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BEYOND AGENCY COSTS: MANAGING THE CORPORATION FOR THE LONG TERM

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INTRODUCTION

To many academic observers of the American corporation, the frequent accounts of staggering corporate debt loads or mass layoffs and plant closings are positive signs that augur optimal minimization of the agency costs of capital. These agency costs (the principal's costs of monitoring and attempting to control the agents)[1] have preoccupied the literature ever

1. *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 308 (1976).

since the publication of Berle and Means' classic, *The Modern Corporation and Private Property*.[2] The public corporation, we were told, made possible vast accumulations of capital, but the widely-dispersed owners of the enterprise had no effective means of monitoring and controlling their ostensible agents, the professional managers.

The "agency cost" analysis still reigns supreme in the academic literature. In this view, the central task for corporate law and policy is to reduce the divergence of interests between shareholders and managers, thus improving returns to equity and, by extension, social welfare. Not surprisingly, then, the spread of the hostile takeover during the 1980s was heralded as a providential vehicle for reducing equity's agency costs.[3] What appeared to the uninitiated as imprudently high levels of debt incurred by successful raiders and "self-raiding" defending targets,[4] were to the cognoscenti in the business schools and law schools valuable efficiency enhancing financing techniques[5] for aligning the interests of shareholders and managers.

We are now reaping the crops sown in the 1980s, and are better able to see that these techniques for reducing agency

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2. ADOLF BERLE & GARDINER C. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

3. *See, e.g.*, Michael C. Jensen, *The Takeover Controversy: Analysis and Evidence, in* CORPORATE RESTRUCTURING & EXECUTIVE COMPENSATION 3, 8-9 (John M. Stern et al. eds., 1989); Frank H. Easterbrook & Daniel R. Fischel, *The Proper Role of a Target's Management in Responding to a Tender Offer*, 94 HARV. L. REV. 1161, 1169-73 (1981). *See also* Lucian A. Bebchuk, Comment, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028, 1046-50 (1981) (critiquing Easterbrook & Fischel's analysis).

The takeover phenomenon also had its critics. *See, e.g.*, LOUIS LOWENSTEIN, WHAT'S WRONG WITH WALL STREET: SHORT-TERM GAIN AND THE ABSENTEE SHAREHOLDER 119-59 (1988); William W. Bratton, Jr., *Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92; Martin Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U. PA. L. REV. 1, 6-33 (1987).

4. A few voices in the wilderness lamented the surge in corporate indebtedness. *See, e.g.*, Lindley H. Clark, Jr. & Alfred L. Malabre, Jr., *Borrowing Binge: Takeover Trend Helps Push Corporate Debt and Defaults Upward*, WALL ST. J., Mar. 15, 1988, at 1; Felix G. Rohatyn, *Junk Bonds and Other Securities Swill*, WALL ST. J., Apr. 18, 1985, at 30; John S.R. Shad, *The Leveraging of America*, WALL ST. J., June 8, 1984, at 28.

5. *See, e.g.*, Michael C. Jensen, *Eclipse of The Public Corporation*, HARV. BUS. REV., Sept.-Oct. 1989, at 61 [hereinafter Jensen, *Eclipse*].

costs carry a price tag of their own that must figure into the social welfare calculus. Recent empirical studies suggest that there is a disturbing linkage between massive corporate leveraging and the further decrease in the nation's already low levels of corporate investment in productive assets and research and development (R&D).[6] For both actual and potential targets, takeover-related corporate restructurings may have hobbled corporate performance and, in the process, American productivity and competitiveness in the global marketplace.

The academic defenders of the takeover decade remain undeterred. They point to gains to target shareholders,[7] and suggest that the painful dislocations that occurred were necessary to trim "fat" from bloated American firms and reduce the retention by American managers of "free cash flow" better deployed elsewhere.[8] With the emergence of anti-takeover legislation[9] and the drying up of credit generally, however, the search is on for new forces to replace the "discipline" of the takeover market. The current round of articles urge the empowerment of institutional shareholders to fill the monitoring vacuum.[10]

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6. *See, e.g.*, National Science Foundation, *An Assessment of the Impact of Recent Leveraged Buyouts and Other Restructurings on Industrial Research and Development Expenditures*, in *Tax Policy Aspects of Mergers and Acquisitions: Hearings Before The House Comm. on Ways & Means*, 101st Cong., 1st Sess. 686 (1989) [hereinafter 1989 NSF Study]; *cf.* BRONWYN H. HALL, CORPORATE RESTRUCTURING AND INVESTMENT HORIZONS, prepared for Harv. Bus. Sch.—Council on Competitiveness Conf. on Corp. Time Horizons and Investment (1991) (focusing on effects of highly leveraged corporate restructurings, rather than takeovers per se) [hereinafter HALL, INVESTMENT HORIZONS]. For discussion of the effects of leveraging, see *infra* notes 131-50 and accompanying text.

7. For reports that takeovers generate substantial gains to target shareholders, *see, e.g.*, Gregg A. Jarrell, et al., *The Market for Corporate Control: The Empirical Evidence Since 1980*, 2 J. ECON. PERSP., Winter 1988, at 49, 51-53; Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. FIN. ECON. 4, 10-14 (1983); Steven N. Kaplan, *Sources of Value in Management Buyouts*, *in* LEVERAGED MANAGEMENT BUYOUTS: CAUSES AND CONSEQUENCES 95, 98-100 (Yakov Amihud ed., 1989). Data concerning the impact on acquiring firms are "more ambiguous." *See* Roberta Romano, *A Guide to Takeovers: Theory, Evidence, and Regulation*, 9 YALE J. ON REG. 119, 123 (1992).

8. *See, e.g.*, Jensen, *Eclipse*, *supra* note 5, at 61-62.

9. *See infra* notes 31-46 and accompanying text.

10. *See, e.g.*, Bernard S. Black, *Agents Watching Agents: The Promise of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992) [hereinafter

The agency costs prescription for the American corporation is one-sided and incomplete. It ignores other costs—affecting innovation and competitiveness—that can harm an American society dependent upon private firms to make long-term investments in productive assets. Society loses when the managers of corporate firms, distracted by threats to their security and power, defensively restructure, thereby incurring debt and bypassing investments that would spur productivity and garner market share in an increasingly global economy.[11]

It is time to reexamine the "managerialism" decried by Berle and Means and their modern-day counterparts.[12] The preoccupation with agency costs has essentially blinded corporate scholars to these long-term costs to innovation and productivity. Indeed, within proper limits, there is a case to be made for a view of the firm that accords substantial independence to management to act in the long-term best interests of the firm, even if this long view clashes with the short-term interests of equity holders.

This article is divided into three parts. Part I briefly reviews the traditional anti-managerialist conception of the corporation and the recent legislative shift toward managerialism in reaction to the perceived excesses of the takeover decade. Part II marshals theory and evidence to suggest that a system that rewards managers who focus exclusively on the short-term interests of shareholders disserves the long-term interests of the corporation. Where markets imperfectly value investments in certain long-term assets (including research and development), managers will act myopically to boost share price by any available means[13] in response to shareholders' "liquidity

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Agents Watching Agents]; Alfred F. Conard, *Beyond Managerialism: Investor Capitalism?*, 22 U. MICH. J.L. REF. 117, 176-77 (1988); George W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, 1989 WIS. L. REV. 881, 907; Ronald J. Gilson & Reinier Kraakman, *Reinventing the Outside Director: An Agenda for Institutional Investors*, 43 STAN. L. REV. 863 (1991) [hereinafter Gilson & Kraakman, *Outside Director*]; *see also* Bernard S. Black, *Shareholder Passivity Reexamined*, 89 MICH. L. REV. 520, 566-75 (1990) (discussing the potential for institutional shareholders to monitor management) [hereinafter Black, *Shareholder Passivity*].

11. Thus, during the takeover decade of the 1980s, levels of corporate investment in long-term productive assets and spending for research and development declined in comparison to our main competitors, Germany and Japan. *See infra* notes 151-63 and accompanying text.

12. *See infra* notes 17-21 and accompanying text, and sources cited therein.

13. *See infra* notes 76-150 and accompanying text for a discussion of

perspective."[14] The agency costs theorists have been missing the point. It is precisely when managers are exclusively preoccupied with the short-term liquidity perspective of shareholders that managers will take actions that undermine the firm's ability to make essential long-term investments in plant, machinery and new product development, and to elicit the cooperation of the firm's employees in promoting long-term economic objectives.

For these reasons, the recent developments in the law that reveal a shift toward managerialism may facilitate advances in corporate productivity, but they, too, offer an incomplete, one-sided solution. This shift toward managerialism deprives courts and shareholders of the most accessible, easily measured criterion for monitoring management performance—the maximization of short-term shareholder value. It threatens, therefore, to exacerbate the persistent problem of managers beholden to no one but themselves. An alternative framework for structuring management incentives for long-term corporate performance is needed. Accordingly, Part III offers a set of preliminary proposals to ensure that management indeed acts in the long-term interests of the firm.

I. ANTI-MANAGERIALISM: THEORY AND PRACTICE

Our legal system presents contrasting visions of the corporation reflecting a conflict that goes to the heart of corporate governance: Is the corporation an entity distinct from its equity holders, and is it to that entity (as opposed to those shareholders themselves) that managers owe duties of care and loyalty? Or, despite the corporate form, is it simply an aggregation of persons (principally its owners, i.e., shareholders) to whom managers owe their exclusive fiduciary duties? If, as this article suggests, the well-being of the corporate entity is not necessarily congruent with the short-term wealth maximization of its shareholders, the choice between these competing models of the firm will be anything but academic for courts evaluating

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managerial and shareholder "myopia," i.e., decisionmaking distorted to neglect long-term interests in favor of the short-term.

14. Investors in the securities of public corporations elect to invest in property characterized in large part by its liquidity. They therefore typically lack a long-term commitment to the underlying enterprise. *See infra* notes 117-30 and accompanying text for a discussion of public shareholders' "liquidity perspective."

managerial decisions and policy makers formulating the law of corporations.

A. *Theory of the Firm: From Managerialism to "Nexus of Contracts"*

Managerialist theory begins with the post-Berle and Means understanding of the modern corporation as involving a separation of the entrepreneurial functions into ownership/risk-bearing and control, with control lodged in the corporate manager rather than in the equity holders.[15] The manager dominates in the managerialist model,[16] a powerful figure, surrounded by widely-dispersed, essentially passive shareholders.

In the broadest sense, the anti-managerialists raise doubts about the legitimacy of powerful corporate management. Following in Berle and Means' footsteps, corporate theorists have struggled to construct an "economic" theory to explain the prevalence of managerialism. The theory ultimately expounded was "the hypothesis of managerial utility maximization,"[17] replete with images of fundamentally self-interested managers, constrained only by the discipline of the capital and product markets.[18]

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15. For Berle and Means, with the separation of control from ownership, the modern public corporation relegated its putative owners to a condition of powerlessness—widely dispersed and incapable of unified action, at the mercy of self-aggrandizing managers who could not easily be removed from office. Berle and Means, *supra* note 2, at 333-51. In their view, the classical economic model (that rational utility-maximizing individuals pursuing their own self-interest in competitive markets, will, if left alone, achieve efficient results and thereby serve the public good) could not usefully be applied to the public corporation. *Id.*

16. *See, e.g.*, WILLIAM J. BAUMOL, BUSINESS BEHAVIOR, VALUE AND GROWTH (1959); ROBIN MARRIS, THE ECONOMIC THEORY OF "MANAGERIAL" CAPITALISM (1964); Felix R. FitzRoy & Dennis C. Mueller, *Cooperation and Conflict in Contractual Organizations*, Q. REV. ECON. & BUS., Winter 1984 at 24, 24; Harvey Leibenstein, *Allocative Efficiency vs. "X-Efficiency,"* 56 AMER. ECON. REV. 392, 397-98 (1966); Robin Marris & Dennis C. Mueller, *The Corporation, Competition, and the Invisible Hand*, 18 J. ECON. LIT. 32, 40-44 (1980).

17. MASAHIKO AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM 35 (1984). *See generally* MARRIS, *supra* note 16; OLIVER E. WILLIAMSON, THE ECONOMICS OF DISCRETIONARY BEHAVIOR: MANAGERIAL OBJECTIVES IN A THEORY OF THE FIRM (1964).

18. Denied perfect information in a world of "bounded rationality," managers adopt an essentially trial-and-error strategy for problem solving, which leads not to optimal solutions but rather to satisfactory ones. *See* John C. Coffee, Jr., *Shareholders Versus Managers: The Strain in the*

Managers, it is argued, will pursue corporate growth to maximize their own utility (i.e., compensation, security, psychic income), even to the exclusion of shareholder wealth maximization.[19] This obsession with growth is blamed for the ultimately disappointing corporate conglomeration explosion of the 1960s and 1970s, which was later to be undone by takeovers and restructuring.[20] Under this view, managers do not pay sufficient attention to maximizing shareholder value, and the central task of corporate law reform is to induce managers to promote shareholder interests.[21]

In the last decade, theorists have also advanced a "nexus of contracts" reformulation of the neoclassical model[22] of the

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Corporate Web, 85 MICH. L. REV. 1, 29 (1986) [hereinafter Coffee, *Shareholders Versus Managers*]. Under this theory, managers will not seek to "profit-maximize," but rather to "profit-satisfice"—i.e., to be profitable enough to prevent shareholders from disinvesting or intervening. *See, e.g.*, HERBERT A. SIMON, MODELS OF MAN: SOCIAL AND RATIONAL 204-05 (1957).

19. For explanations of managers' preference for growth over shareholder welfare, see Coffee, *Shareholders Versus Managers*, *supra* note 18, at 29 (different risk tolerances of managers and shareholders); Jensen, *Eclipse*, *supra* note 5, at 66 (the enhanced prestige and social and political power that result from corporate growth "creates a cultural bias toward growth"); Oliver E. Williamson, *Managerial Discretion and Business Behavior*, 53 AM. ECON. REV. 1032, 1034 (1963) (personal utility derived from growth, increased staff).

20. *See generally* David J. Ravenscraft & F.M. Scherer, *The Long-Run Performance of Mergers and Takeovers*, *in* PUBLIC POLICY TOWARD CORPORATE TAKEOVERS 34 (Murray L. Weidenbaum & Kenneth W. Chilton eds., 1988); *infra* note 106 (conglomerate mergers and price earnings ratios).

21. These theories, which largely predate the "takeover decade" of the 1980s, understate the constraints placed on managers by today's markets for capital and corporate control. Indeed, Part II of this article will suggest there is reason to suspect that the market may be considerably less efficient (at least in valuing "soft" information about long-term investment) than is generally believed, and that managers may be overly concerned about short-sighted shareholders whose investment horizons do not extend beyond current share price on the resale market. *See infra* notes 72-116.

22. The neoclassical model of the firm begins with a tradition that views the firm as a "black-box," combining factors of production (*inter alia*, capital and labor) with firm-specific resources under the control of its owner-managers to produce output for the market, thereby maximizing profits. *See* Oliver Hart, *An Economist's Perspective on the Theory of the Firm*, 89 COLUM. L. REV. 1757, 1758 (1989) ("Neoclassical theory views the firm as a set of feasible production plans."). The residual (revenue from sales less payments to the various factors of production), if any, is

firm,[23] writing that corporations "are simply legal fictions which serve as a nexus for a set of contracting relationships among individuals."[24] The firm consists entirely of a set of related contracts among factors of production and attendant transaction costs. Shareholders are viewed not as "owners" of the corporation, but as suppliers of financial "input" who "contract" for, *inter alia*, a variable return (the residual).[25]

In this model, the firm has no existence or interests beyond those of the individual contracting parties. It would be impossible, then, for managers to represent "the corporation." Thus, the statutes and common law rules requiring them to act in the "best interests of the corporation" are incapable of meaningful application.[26] Because firm ownership is rendered

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to be paid to the owner-manager, i.e., the equity holder, who is also considered the sole bearer of residual risk. *See generally* Armen A. Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AM. ECON. REV. 777 (1972); Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 J. POL. ECON. 288 (1980) [hereinafter Fama, *Agency Problems*]; Eugene F. Fama & Michael C. Jensen, *Separation of Ownership and Control*, 26 J.L. & ECON. 301 (1983); Jensen & Meckling, *supra* note 1.

23. There is considerable literature on the "nexus of contracts" model. *See, e.g.*, Steven N.S. Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983); Fama & Jensen, *supra* note 22; Daniel R. Fischel, *Labor Markets and Labor Law Compared with Capital Markets and Corporate Law*, 51 U. CHI. L. REV. 1061 (1984); Jensen & Meckling, *supra* note 1; OLIVER E. WILLIAMSON, CORPORATE GOVERNANCE (University of Toronto Working Paper No. WSVI-16, 1984). For an overview of the literature, see Henry N. Butler, *The Contractual Theory of the Corporation*, GEO. MASON U.L. REV., Summer 1989, at 99. Not all assessments have been positive. *See, e.g.*, William W. Bratton, Jr., *The "Nexus of Contracts" Corporation: A Critical Appraisal*, 74 CORNELL L. REV. 407 (1989); Victor Brudney, *Corporate Governance, Agency Costs, and the Rhetoric of Contract*, 85 COLUM. L. REV. 1403 (1985); Melvin A. Eisenberg, *New Modes of Discourse in Corporate Law Literature*, 52 GEO. WASH. L. REV. 582 (1984).

24. Jensen & Meckling, *supra* note 1, at 310 (emphasis omitted).

25. Shareholders are "more optimistic," Alchian & Demsetz, *supra* note 22, at 789 n.14, about the firm's prospects than other investors, but do not otherwise differ from them. Shareholders contract for greater potential return at greater risk, believing the firm will prosper. Bondholders are more pessimistic, choosing less risk in return for a more certain payoff.

26. "[T]he nature and significance of [the] transformation [of corporate theory] remain obscure because, in some sense, the revolution has simply replaced one legal metaphor, the trust, with another legal metaphor, the nexus of contracts." Lewis A. Kornhauser, *The Nexus of Contracts Approach to Corporations: A Comment on Easterbrook and Fischel*, 89

meaningless within the "nexus of contracts" corporation,[27] any concern about the separation of ownership from control is without content. Indeed, this theory dispenses once and for all with the anti-managerialist critique of corporate governance: since the firm is not a hierarchical authority-based enterprise, there is no management "power" at all—only those functions delegated to managers through sets of negotiated arm's-length transactions.

In the "nexus of contracts" firm, equity has no automatic claim to a particular role in corporate governance. Although efficiency concerns are said to dictate that the equity holders be the monitors,[28] other efficiency-oriented views are possible that place the anti-managerialist critique in a very different light.[29]

Admittedly, the "nexus of contracts" model has been criticized as based on unrealistic assumptions that are of limited utility to shareholders, managers and other participants who inevitably experience asymmetries of power and information.[30] Despite its problems, however, the nexus of contracts theory invites a reexamination of the traditional principles of corpora-

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COLUM. L. REV. 1449, 1449 (1989).

27. *See* Fama, *Agency Problems*, *supra* note 22, at 290 ("ownership of the firm is an irrelevant concept"); Alchian & Demsetz, *supra* note 22, at 789, n.14.

28. Some commentators suggest that this governance structure flows directly from the need to minimize agency costs within the corporation. By giving the monitor the claim to the residual (as corporate form traditionally does), we give her the maximum incentive to monitor well. This incentive is assured, however, only when the monitor is motivated by her claim to the residual. *See* Alchian & Demsetz, *supra* note 22, at 782.

29. Consider, for example, Professor Aoki's vision of management as performing a critical coordinative role in the "co-operative game" between shareholders and employees. Aoki, *supra* note 17, at 61. A co-operative game is one in which "the players can conclude a binding agreement as to what outcome will be chosen to exploit the possibility of common interests." *Id.* This process involves communication and coordinated action, *id.*, rather than confrontation and rigidity. The manager's function under such a model is to act as the coordinator of equity and labor inputs, a more richly textured role than that of the self-interested utility maximizer of the managerialist critique.

30. *See, e.g.*, Brudney, *supra* note 23, at 1405; Robert C. Clark, *Agency Costs Versus Fiduciary Duties*, *in* PRINCIPALS AND AGENTS: THE STRUCTURE OF BUSINESS 55, 61-62 (John W. Pratt & Richard J. Zeckhauser eds., 1985); David Millon, *Theories of the Corporation*, 1990 DUKE L.J. 201, 231 n.122.

tion law by loosening the concept of ownership from its common law roots, and thereby facilitating a fundamental re-evaluation of the role of outside equity in the public corporation.

B. *Reaction to "Hostile" Takeovers*

1. Anti-Takeover Legislation

As a matter of positive law, managers are obliged to act in the "best interests of the corporation."[31] At least until recently, this standard was for all intents and purposes synonymous with the "best interests of the shareholders."[32] Managers are said to pursue the best interests of the corporation when they maximize profit,[33] which in turn increases share value (hence, shareholder wealth). Under this view, there is little justification for management interference with transactions that would bring shareholders the best possible price for their shares.[34] The classic example of such interference involves management tactics that preclude willing shareholders from accepting hostile tender offers at substantial premiums above market price.[35] However, notwithstanding shareholders' desire to sell, managers are increasingly being permitted to resist such bidders "in the best interests of the corporation."[36] And, despite

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31. *See, e.g.*, MODEL BUSINESS CORP. ACT 3d § 8.30(a)(3) (1992).

32. *See, e.g.*, A.B.A. Sec. Corp., Banking and Bus. L., *Corporate Director's Guidebook*, 33 BUS. LAW. 1591, 1601 (1978). The Delaware courts have repeatedly described management's responsibilities as duties toward the shareholders and the corporation simultaneously. *See, e.g.*, Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985); Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984); Guth v. Loft, Inc., 5 A.2d 503, 510 (Del. 1939), *aff'd*, 19 A.2d 721 (Del. 1941).

33. *See* THE AMERICAN LAW INSTITUTE PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, § 2.01, Tentative Draft No. 11 (April 25, 1991) [hereinafter ALI PROJECT]; ROBERT CLARK, CORPORATE LAW 17-19 (1986). *But see* Henry T.C. Hu, *Risk, Time, and Fiduciary Principles in Corporate Investment*, 38 UCLA L. REV. 277, 305-06 (1990) (suggesting that focus on accounting measures, although it benefits corporation's financial profile, prompts managers to make overly risk-averse investment decisions that do not maximize gains in shareholder welfare).

34. Managers have a somewhat broader range of discretion with respect to asset sales than in responding to tender offers. *See, e.g.*, Easterbrook & Fischel, *supra* note 3.

35. The question whether the market could be mispricing target shares is central to the debate over management defensive tactics. *See infra* notes 76-116 and accompanying text.

36. *See infra* notes 47-63 and accompanying text.

considerable disquiet in academic circles,[37] this essentially managerialist view continues to gain legal and popular support.[38]

The newest variety of anti-takeover statutes, enacted in response to the takeovers of the 1980s—the so-called "stakeholder" statutes[39]—depart (often explicitly[40]) from the traditional premise of shareholder primacy by authorizing the consideration of nonshareholder as well as shareholder interests.[41] In addition to permitting directors to consider specified

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37. *See, e.g.*, Lucian A. Bebchuk, *The Case for Facilitating Competing Tender Offers*, 95 HARV. L. REV. 1028 (1982); Easterbrook & Fischel, *supra* note 3; Jeffrey N. Gordon, *Corporations, Markets and Courts*, 91 COLUM. L. REV. 1931 (1991).

38. *See, e.g.*, Paramount Communications, Inc. v. Time, Inc., 571 A.2d 1140 (Del. 1989); Fred S. McChesney and William J. Carney, The Theft of Time, Inc.?, Regulation, Spring 1991 at 78; *infra* notes 47-71 and accompanying text.

39. About 33 states have enacted some form of anti-takeover statute. These statutes have generated a vast literature (supporting and critical) in a short period of time. *See, e.g.*, Symposium, *Corporate Malaise—Stakeholder Statutes: Cause or Cure?*, 21 STETSON L. REV. 1 (1991); Paul N. Cox, *The Indiana Experiment in Corporate Law: A Critique*, 24 VAL. U. L. REV. 185 (1990); David A. Millon, *Redefining Corporate Law*, 24 IND. L. REV. 223, 240-46 (1991); Lyman Johnson & David Millon, *Missing the Point About State Takeover Statutes*, 87 MICH. L. REV. 846 (1989); Roberta C. Karmel, *The Duty of Directors to Non-Shareholder Constituencies in Control Transactions—A Comparison of U.S. and U.K. Law*, 25 WAKE FOREST L. REV. 61 (1990); Alexander C. Gavis, Comment, *A Framework for Satisfying Corporate Directors' Responsibilities Under State Nonshareholder Constituency Statutes: The Use of Explicit Contracts*, 138 U. PA. L. REV. 1451 (1990).

40. *See, e.g.*, 15 PA. CONS. STAT. ANN. § 515(b) (Purdon Supp. 1992) ("[T]he board . . . shall not be required . . . to regard . . . the interests of any particular group [including shareholders] affected by such action as a dominant or controlling interest or factor."). For a list and comparative analysis of current stakeholder statutes, *see* Steven M.H. Wallman, *The Proper Interpretation of Corporate Constituency Statutes and Formulation of Director Duties*, 21 STETSON L. REV. 163, App. at 194-96 (1991).

41. The Ohio statute makes consideration of shareholder constituencies mandatory. *See* OHIO REV. CODE ANN. § 1701.59(E) (Baldwin Supp. 1989) ("director[s] . . . shall consider the interests of the . . . shareholders and . . . may consider [other constituencies]"). Connecticut makes consideration of nonshareholder constituencies mandatory. CONN. GEN. STAT. ANN. § 33-313(e) (West Supp. 1992) ("director[s] . . . shall consider . . . [long-term and short-term interests of the corporation, the shareholders, and nonshareholder constituencies]"). Most states, however, leave consid-

nonshareholder constituencies, some statutes expressly authorize directors to consider the short-term and long-term interests of the corporation[42] and/or its shareholders.[43]

These statutes reflect widespread concern over the substantial disruptions to communities and workers, downgrading of senior (hitherto investment grade) debt securities, and other social dislocations that sometimes follow the "bust up" takeover.[44] Their enactment[45] may herald a shift from an exclu-

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eration of the interests of the various constituencies to the directors' discretion. The new constituencies include employees, creditors, customers and even communities as legitimate claimants to directors' consideration. *See, e.g.*, 15 PA. CONS. STAT. ANN. § 515(a) (Purdon Supp. 1992) (permitting consideration of the effects of corporate action upon "shareholders, members, employees, suppliers, customers, . . . creditors of the corporation, . . . [and] communities in which offices or other establishments of the corporation are located").

Some statutes relieve directors of the obligation to weigh shareholder concerns more heavily than others. *See* PA. CONS. STAT. ANN. § 515(b), *supra* note 40. *Accord*, N.Y. BUS. CORP. LAW § 717(b) (McKinney Supp. 1993) (expressly rejecting the idea that its stakeholder statute creates any new fiduciary duties or abrogates any existing ones).

42. The explicit recognition of short-term and long-term interests reflects the legislature's determination that there is in fact a difference between the two measures of welfare. This proposition is disputed by the economic theorists who believe that today's values include tomorrow's, discounted to their present value. *See* discussion *infra* notes 76-79 and accompanying text.

43. *See, e.g.*, N.Y. BUS. CORP. LAW § 717(b):

> In taking action, including, without limitation, action which may involve or relate to a change or potential change in the control of the corporation, a director shall be entitled to consider, without limitation, (1) *both the long-term and the short-term interests of the corporation and its shareholders* and (2) the effects that the corporation's actions may have in the short-term or in the long-term upon any [specified nonshareholder constituencies.]

Id. (emphasis added). New York's legislature makes explicit the distinction between the corporation's and its shareholders' interests. The section includes as relevant considerations not only the usual nonshareholder interests, but also:

> (i) the prospects for potential growth, development, productivity and profitability of the corporation; . . . (iii) the corporation's retired employees and other beneficiaries receiving or entitled to receive retirement, welfare or similar benefits [from the corporation]; . . . and (v) the ability of the corporation to provide, as a going concern, goods, services, employment opportunities and employment benefits and otherwise to contribute to the communities in which it does business.

Id. §§ 717(b)(i), (iii) and (v).

44. Motives for legislation are notoriously slippery and it has been

sively shareholder-centered model toward an avowedly managerialist conception of the firm.[46]

2. Deferential Review of Defensive Tactics in Delaware

Although Delaware has not enacted a "stakeholder" statute,[47] its judiciary has for some time been struggling with the

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suggested that these statutes are really the result of lobbying by frightened entrenched management groups thrown into a startling alliance with labor. *See, e.g.*, Roberta Romano, *The Political Economy of Takeover Statutes*, 73 VA. L. REV. 111, 134-38 (1987). Nevertheless, other commentators have observed the substantial wealth transfers caused by hostile takeovers. *See, e.g.*, John C. Coffee, Jr., *Unstable Coalitions: Corporate Governance As a Multi-Player Game*, 78 GEO. L.J. 1495 (1990) [hereinafter *Unstable Coalitions*]; Coffee, *Shareholders Versus Managers*, *supra* note 18, at 104; Kenneth B. Davis, Jr., *Epilogue, The Role of the Hostile Takeover and the Role of the States*, 1988 WIS. L. REV. 491, 493. Such social upheavals are legitimately the concern of the legislature. *See, e.g.*, Coffee, *Shareholders Versus Managers*, *supra* note 18, at 108; Coffee, *Unstable Coalitions*, *supra*, at 1548-49; John C. Coffee, Jr., *The Uncertain Case for Takeover Reform: An Essay on Stockholders, Stakeholders and Bust-ups*, 1988 WIS. L. REV. 435, 446-49; Morey W. McDaniel, *Stockholders and Stakeholders*, 21 STETSON L. REV. 121 (1991); Katherine Van Wezel Stone, *Employees as Stakeholders Under State Nonshareholder Constituency Statutes*, 21 STETSON L. REV. 45 (1991); Wallman, *supra* note 40.

45. Many anti-takeover statutes seem to fit comfortably within the contractual model of the corporate enterprise since they permit corporations to "opt out" of their impact through a charter amendment or by-law. *See, e.g.*, PA. CONS. STAT. ANN. § 511(a) and (b) (Purdon Supp. 1992). *See also* Michael W. Armstrong, *At Least 67 Firms Buck Act 36*, 9 PHILA. BUS. J., July 30, 1990, at 1 (of 67 corporations that notified state of intent to opt out, 25 opted out of entire section). Of course, in a federal system, corporations are free to reincorporate under another state's laws.

46. Such an expanded institutional vision seems not unrelated to the responsible corporate citizen envisioned in the classic article, E. Merrick Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932). Corporate social responsibility need not be cast solely in terms of fairness, charity or altruism. A self-interested society struggling to succeed in a global economy cannot afford to allow the short-term gains of one group to divert resources necessary for competition in that economy. It may be that the primacy of short-term shareholder financial return, rather than a more broadly focused corporate mission, is contributing at least in part to the loss of productivity, and failure of competitiveness in U.S. industry. *See infra* Part II.A.

47. Delaware's takeover statute is a so-called "business combination" statute. DEL. CODE ANN. tit. 8, § 203 (Supp. 1991). Rather than creating

tension between exclusive devotion to short-term shareholder interests and recognition of a reconceptualized corporate entity.[48] The arena for the struggle in Delaware as elsewhere has been the hostile takeover.

a. The *Unocal* Context

The issue is typically presented in litigation challenging management's tactics in the face of a hostile takeover bid.[49] Shareholder welfare dominated the reasoning of earlier cases, many of which nevertheless approved (as benefitting shareholders) defensive tactics that drove off potential acquirers.[50]

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obstacles to takeovers or injecting nonshareholder interests into the deliberative mix, Delaware imposes a moratorium on post-takeover transactions without the approval of target management. The provision is not applicable to takeovers that acquire at least 85% of target shares. Title 28, § 203(a)(2).

48. The problem of unbundling the director's duty "to the corporation and its shareholders" was addressed by Chancellor Allen in a recent decision of the Delaware Chancery Court:

> [T]his particular phrase masks the most fundamental issue: to what interest does the board look in resolving conflicts between interests in the corporation that may be characterized as "shareholder long-term interests" or "corporate entity interests" or "multi-constituency interests" on the one hand, and interests that may be characterized as "shareholder short-term interests" or "current share value interests" on the other?

TW Services, Inc. Shareholders Litigation, [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92,178 n.5 (Del. Ch. 1989). For a thoughtful analysis of the contributions made by Chancellor Allen to this line of cases, see Stephen J. Massey, *Chancellor Allen's Jurisprudence and the Theory of Corporate Law, Part V*, 17 Del. J. Corp. L. 683 (1992).

49. *See, e.g.*, Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (defensive repurchase of shares by target management, excluding shares of raider); Robert M. Bass Group, Inc. v. Evans, 552 A.2d 1227 (Del. Ch. 1988) (defensive restructuring by target management); Ivanhoe Partners v. Newmont Mining Corp., 535 A.2d 1334 (Del. 1987); City Capital Assocs. v. Interco Inc., 551 A.2d 787 (Del. Ch. 1988) (defensive responses by target management, including refusal to redeem poison pill rights plan).

50. *See, e.g.*, *Unocal*, 493 A.2d at 958-59; *Ivanhoe Partners*, 535 A.2d at 1345; Moran v. Household Int'l, Inc. 500 A.2d 1346, 1356 (Del. 1985) (poison pill put in place to protect shareholders from unfair takeover attempts).

Recent cases have included explicit references to other constituencies beneath the "corporate interests" umbrella. *See, e.g.*, *Unocal*, 493 A.2d at 955 (directors may justify defensive tactics by considering "the [takeover's] impact on 'constituencies' other than shareholders (i.e., creditors, customers, employees, and perhaps even the community generally)").

The relevant point of departure is the Delaware Supreme Court's decision in *Unocal Corp. v. Mesa Petroleum Co.*[51] In that case, the court declined to apply the standard business judgment rule to insulate from liability a target's defensive repurchase of shares program that excluded the shares owned by the corporate raider. Before the target management could claim protection under the business judgment rule, the directors would have to (a) "show [by proving good faith and reasonable investigation] that they had reasonable grounds for believing that a danger to corporate policy and effectiveness existed"[52] and (b) demonstrate that the defensive tactic in question "is reasonable in relation to the threat posed."[53] Subsequent cases revealed that hostile offers (including all cash, all shares offers) might, in theory, pose threats to shareholders due to their coercive nature or simple inadequacy.[54]

The problem here is one of informational asymmetry. Target management claims to know that the corporation is worth more than is being offered by the raider, and fully expects to achieve those gains; nevertheless, the majority of shareholders may not believe management and may accept an inadequate offer as a result.[55] For some Delaware courts after *Unocal*, this kind of threat to shareholders did not justify open-ended defensive tactics as long as management had adequate time to address the issues. Thus, for a time, there seemed reason to doubt whether tactics that would permanently preclude willing shareholders from accepting hostile bids could pass the *Unocal* test. However, the recent cases of *TW Services, Inc. Shareholders Litigation*,[56] and *Paramount Communications v. Time, Inc.*,[57] suggest a reconsideration is taking place.

This view was subsequently qualified in Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 176 (Del. 1986) (consideration of nonshareholder constituencies appropriate only if "there [is] some rationally related benefit accruing to the stockholders"); Mills Acquisition Co. v. Macmillan, Inc., 559 A.2d 1261, 1282 n.29 (Del. 1987) (consideration of non-shareholder constituencies appropriate only if there is "some reasonable relationship to general shareholder interests").

51. 493 A.2d 946 (Del. 1985).

52. *Id.* at 955.

53. *Id.*

54. *See, e.g., City Capital*, 551 A.2d at 797-98.

55. *See Unocal*, 493 A.2d at 953.

56. [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334.

57. 571 A.2d 1140 (Del. 1989).

b. Acknowledging Threats to the "Corporate Entity": *TW Services* and *Paramount*

In both *TW Services* and *Paramount*, the Delaware courts sustained management efforts to thwart unwanted takeovers. These decisions openly recognize that management may act to avert a threat to the "corporate entity."[58] Chancellor Allen explained in *Paramount* that Delaware precedents "did not establish that . . . [the] corporate entity has no distinct legally cognizable interest that the . . . [all cash, all shares offer] endangers."[59] A hostile offer could pose a threat to corporate long run values[60] that would justify defensive tactics, even if those tactics negatively affected short-term share price.

The Delaware Supreme Court, on appeal in *Paramount*, affirmed the result on different reasoning. Under section 141(a) of the Delaware code,[61] the court reasoned, directors have the "authority to set a corporate course of action, including time frame, designed to enhance corporate profitability."[62] Therefore, they deemed short-term versus long-term focus an irrelevant consideration. "[D]irectors, generally, are obliged to charter a course for a corporation which is *in its best interest* without regard to a fixed investment horizon . . . . [They are] not under any *per se* duty to maximize shareholder value in the short term, even in the context of a takeover."[63]

c. The *Revlon* Exception

In both *TW Services* and *Paramount*, the Delaware courts

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58. *Paramount*, slip op. at 72.

59. *Id.*

60. *See also TW Services* at 92,178 & n.6 ("directors, in managing the business and affairs of the corporation, may find it prudent (and are authorized) to make decisions that are expected to promote corporate (and shareholder) long run interests, even if short run share value can be expected to be negatively affected"; such decisions might involve research and product development, personnel training and compensation, charitable and community financial support) (citations omitted).

61. The section provides in pertinent part:

> (a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation.

DEL. CODE ANN. tit. 8, § 141(a) (Supp. 1991).

62. *Paramount*, 571 A.2d at 1150.

63. *Id.* (emphasis added).

deferred to management's discretion in deciding to repel the takeover bid.[64] There is, however, a set of circumstances in which Delaware law apparently obliges directors to maximize short-term gain for its shareholders: when the directors have put the corporation "in play," i.e., when it is "apparent to all that the break-up of the company [is] inevitable."[65] In *Revlon*, the Delaware court decided that, since the target board itself had put the corporation "in play," its defensive strategies were inconsistent with its fiduciary duty to conduct a fair auction and to obtain the highest share price for its shareholders.[66] Other constituencies and concerns fell out of the picture entirely.

Although the court in *Revlon* overrode the board's defensive strategies against the hostile bidder, Pantry Pride, the board itself had initiated the auction process (essentially conceding that Revlon would be sold to *someone*) by agreeing to a friendly leveraged buyout by Forstmann Little and Co.[67] The court reasoned that once the board made the business decision to break up the corporation, the board's duty was transferred

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64. The courts did so for different reasons. In *Paramount*, the court was satisfied that management met its burden under the *Unocal* test. *Paramount*, 571 A.2d at 1154. In *TW Services*, the court concluded that the tender offeror's merger condition was critical; mergers are traditionally straightforward business decisions committed to board discretion and therefore, "the board's decision with respect to it [would be] reviewed under the traditional business judgment approach." [1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,334, at 92188.

Professors McChesney and Carney disapprove of all the "dubious bits of judicial intervention" undertaken by the Delaware courts, including *Unocal*. In their view, all such departures from the business judgment rule—a rule according deference to managers' decisions in the absence of self-interest—are unwarranted since the "rationale for the business judgment rule is just as applicable in takeover cases as in others" and courts cannot distinguish self-interested transactions from disinterested ones. *See* McChesney & Carney, *supra* note 38, at 82.

65. *Revlon*, 506 A.2d at 182. The easy cases involve target corporation board action that clearly establishes the company is "for sale." At that point, the "directors' role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company." *Id.*

66. *Revlon*, 506 A.2d at 177.

67. The *Revlon* board was attempting to defeat a hostile takeover by Pantry Pride, Inc. *Id.* at 177. It was enjoined from consummating, *inter alia*, a lock-up option with its "white knight," Forstmann Little and Co., and a promise to deal with it exclusively. *Id.* at 184-85.

from "the corporation" to its shareholders.[68]

Much has been written about the difficulty of determining which actions trigger *Revlon*.[69] Perhaps the focus should be redirected from the kind of transaction[70] to the ultimate decisionmaker. In *Paramount*, the Delaware Supreme Court rejected plaintiffs' *Revlon* claim because of "the absence of any substantial evidence to conclude that *Time's board*, in negotiating with Warner, *made the dissolution or break-up of the corporate entity inevitable* . . . ."[71] The operative words here are "Time's board"—the court recognizing that the ultimate disposition of a corporation's future should, in the first instance, be a matter for its own board's discretion. Seen in this light, and given the Revlon board's initial responsibility for putting the corporation in play, the *Revlon* analysis will yield an appropriate application of deferential managerialism that allows a target board to decide whether its long-term corporate strategies should prevail over short-term gains.

II. THE COSTS OF SHORT-TERM DECISIONMAKING

The enactment of state "stakeholder" statutes and the Delaware courts' increased receptivity to defensive tactics by target managements have disturbed many academic commentators. Professor Michael Jensen worries that, with the apparent de-

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> The Revlon board's authorization permitting management to negotiate a merger or buyout with a third party was a recognition that the *company was for sale*. The duty of the board had thus changed from the preservation of Revlon as a corporate entity to the maximization of the company's value at a sale for the stockholders' benefit.

Id. at 182 (emphasis added).

69. An interesting question under this analysis is what (in addition to management's decision to initiate bidding or its abandonment of long-term planning to seeking an alternative break-up transaction in the face of a hostile bid) triggers *Revlon*. *See, e.g.*, Ronald J. Gilson & Reinier Kraakman, *What Triggers Revlon?*, 25 WAKE FOREST L. REV. 37 (1990); Portia Policastro, Note, *When Delaware Corporate Managers Turn Auctioneers: Triggering the Revlon Duty After the Paramount Decision*, 16 DEL. J. CORP. L. 187 (1991). Professor Massey concludes that the cases reveal no "settled, considered view of what triggers *Revlon*." Massey, *supra* note 48, at 772.

70. Some cases focus on "change of control," others on "sale" of the corporation or its control, others on the "inevitable breakup" of the corporation. *See* Massey, *supra* note 48, at 769-73 and nn. 406-28.

71. *Paramount*, 571 A.2d at 1150 (emphasis added).

mise of the "hostile" takeover, managers will retain "free cash flow" with which to pursue their self-interested agenda, rather than releasing funds that could be better deployed elsewhere.[72] Professor Jeffrey Gordon, in a recent piece on the *Paramount* decision, fears that the legal and popular culture may be rejecting the virtues of free markets.[73] The literature abounds with diagnoses of "shareholder passivity" and calls to empower institutional investors as the new vanguard to monitor wayward corporate managers for the sake of maximizing share value (and in the process, allocative efficiency).[74]

As the discussion below reveals, there are significant costs associated with legal rules or takeover threats that compel managers to be concerned exclusively with maximizing short-term values for the firm's equity holders, a constituency that tends to devalue long-term investment goals in favor of short-term financial profits. If managerial horizons are reduced in this manner, the firm will underinvest in research and development and other long-term productive assets; it will also act opportunistically with employees who have made firm-specific investments in the firm, inducing, in turn, less than optimal effort and cooperation from these workers. These costs, referred to below as problems of "investment horizon" and "labor noncooperation," detract from the productive capacity of the firm and, by extension, the productive capacity of our national economy.[75]

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72. *See* Jensen, *Eclipse*, *supra* note 5, at 66-67 (managers retain cash to increase the size of their companies, which in turn enhances the "social prominence, public prestige, and political power of senior executives").

73. *See* Gordon, *supra* note 37, at 1971-82.

74. *See, e.g.*, Black, *Agents Watching Agents*, *supra* note 10, at 813; Black, *Shareholder Passivity Reexamined*, *supra* note 10; Conard, *supra* note 10, at 126-30; Dent, *supra* note 10, at 903-07; Gilson & Kraakman, *Outside Director*, *supra* note 10, at 877-78.

75. In the analysis that follows, I do not address the merits of assuming that social welfare can be equated with profit-maximization for the firm. This is hardly an indisputable assumption. Certain decisions such as plant closings impose external costs on affected communities. Such communities may have made firm-specific commitments of property and resources, may have forgone tax payments in exchange for assurances of continued corporate residence now to be abandoned, and may now be forced to assume the welfare costs of displaced workers, suppliers or customers. Indeed, one may ask whether the avoidance of these costs by the firm (in the long or short term) does not shift them less efficiently to the government and the public. An overall assessment of social welfare

A. *The Problem of Investment Horizon*

1. Managerial Myopia

a. Imperfect Markets: Valuation of Long-term Investments

For adherents of the efficient market hypothesis (EMH),[76] any discussion of short-term versus long-term interests is misguided.[77] Common stock prices should, in a perfectly efficient market, reflect the sum of all dividends and other payouts expected to be paid in the future, discounted to their present value.[78] Under this view, pursuit by managers of gain for shareholders (e.g., enhanced share value) inevitably leads to a "bigger pie" overall, and any quibbling about social disloca-

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could not overlook these costs, and would consider the advisability of imposing some portion of them upon the firm.

76. The hypothesis was formulated in the 1960s, *see, e.g.*, Benoit Mandelbrot, *Forecasts of Future Prices, Unbiased Markets, and "Martingale" Models*, 39 J. BUS. 242 (1966); Paul A. Samuelson, *Proof that Properly Anticipated Prices Fluctuate Randomly*, 6 INDUS. MGMT. REV. 41 (1965), *reprinted in* 3 THE COLLECTED SCIENTIFIC PAPERS OF PAUL A. SAMUELSON 782-90 (Robert C. Merton ed., 1972); *see also* Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970), and continues to dominate the literature. *See, e.g.*, JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE (1973); Frank H. Easterbrook & Daniel R. Fischel, *Mandatory Disclosure and the Protection of Investors*, 70 VA. L. REV. 669, 680-82 (1984); Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984); Christopher P. Saari, Note, *The Efficient Capital Market Hypothesis, Economic Theory, and the Regulation of the Securities Industry*, 29 STAN. L. REV. 1031 (1977).

77. As Professor Macey observes:

> [T]he distinction between maximizing firm value for the present versus maximizing firm value for the future is wholly false. What matters in determining the value of a firm's shares is the present value of all flows—present and future.

Jonathan R. Macey, *State Anti-Takeover Legislation and the National Economy*, 1988 WISC. L. REV. 467, 481. *But see* Thomas L. Hazen, *The Short-Term/Long-Term Dichotomy and Investment Theory: Implications for Securities Market Regulation and for Corporate Law*, 70 N. CAR. L. REV. 137, 139 (1991) (distinguishing throughout between short-term shareholder interests and long-term corporate interests).

78. *See, e.g.*, R.A. BREALEY, AN INTRODUCTION TO RISK AND RETURN FROM COMMON STOCKS 67-68 (2d ed. 1983); VICTOR BRUDNEY & MARVIN CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 479-482 (2d ed. 1987); BENJAMIN GRAHAM ET AL., SECURITY ANALYSIS: PRINCIPLES AND TECHNIQUE 480-481 (4th ed. 1962).

tion[79] or effect upon investment horizons (since the short term *is* the discounted long term in an efficient capital market) betrays a misunderstanding of the economic principles at work.

However, recent studies concerning the EMH, in particular the semi-strong form of the hypothesis,[80] suggest that such strong assumptions[81] of market efficiency are misplaced.[82]

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79. In economic terms, questions concerning possible wealth transfers from nonshareholder corporate constituencies to shareholders as a result of managerial decisionmaking concern the distribution of wealth, rather than efficiency per se. *See, e.g.*, Jensen, *Eclipse*, *supra* note 5, at 71 ($300 million diminution in value to pre-LBO bondholders deemed a "small sum" compared to wealth created by LBO). On the distinction between efficiency (viewed in terms of the Kaldor-Hicks criterion as transactions where aggregate benefits outweigh the aggregate costs of achieving those benefits) and equity, *see generally* A. MITCHELL POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 7 (1983); *see also* Coffee, *Shareholders Versus Managers*, *supra* note 18, at 104-105.

80. There are three versions of the hypothesis. (1) The strong form asserts that all information (including non-public information) is reflected in stock price. *See, e.g.*, RICHARD A. BREALEY & STEWART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 270 (3d ed. 1988) ("prices reflect not just public information but *all* information that can be acquired by painstaking fundamental analysis of the company and economy") (emphasis in original). (2) The weak form asserts that all information concerning past price movements is reflected in present stock price. *See id.* at 270-72. (3) The form that has predominated is the semi-strong form, which asserts that current prices incorporate and adjust to reflect all publicly available information. *See id.* at 270; JACK CLARK FRANCIS, INVESTMENTS: ANALYSIS AND MANAGEMENT 651 (4th ed. 1986) ("The semi-strong efficient market hypothesis requires that all available relevant *public* information . . . be fully reflected in security prices") (emphasis in original).

81. Some proponents of market efficiency conclude that trading itself does not influence efficient pricing. For example, finance theory posits that demand for shares is highly (perhaps perfectly) elastic. *See, e.g.*, Brealey & Myers, *supra* note 80, at 296-98. Thus, investors should be able to buy or sell large quantities of shares without affecting market price. *See, e.g.*, Frank H. Easterbrook, *Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information*, 1981 SUP. CT. REV. 309, 335-36; Gilson & Kraakman, *Mechanisms of Market Efficiency*, *supra* note 76, at 629-34. The notion of perfectly elastic demand has gained currency through the prevailing Capital Asset Pricing Model (CAPM), one premise of which is that investors share identical estimates of the risks and returns of particular stocks. By contrast, Professor Stout offers a "heterogeneous beliefs" model of stock pricing that recognizes that investor "estimates of stock value may differ widely." Lynn A. Stout, *Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law*, 99 YALE L.J. 1235, 1245 (1990). Under this model, which she suggests is supported by empirical evidence, the demand for shares

Market pricing of shares, while generally informationally efficient in reflecting currently available *public* information,[83] may not be quite as efficient as is widely believed when it comes to fundamental valuation.[84] In other words, under this

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is "downward-sloping" and large transactions do alter stock prices.

82. *See* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information, and Securities Research*, 60 N.Y.U. L. REV. 761, 764 (1985) ("[T]he legal rush to embrace and apply the efficient market hypothesis has been overly precipitous and occasionally unwise."). Recent scholarship has cast doubts on both EMH's empirical and theoretical claims, *see, e.g.*, Sanford J. Grossman & Joseph E. Stiglitz, *On the Impossibility of Informationally Efficient Markets*, 70 AM. ECON. REV. 393 (1980); *Symposium on Some Anomalous Evidence Regarding Market Efficiency*, 6 J. FIN. ECON. 95 (Michael C. Jensen ed., 1978); Stephen J. Brown & Christopher B. Barry, *Anomalies in Security Returns and The Specification of The Market Model*, 39 J. FIN. 807 (1984); Donald B. Keim & Robert F. Stambaugh, *A Further Investigation of The Weekend Effect in Stock Returns*, 39 J. FIN. 819 (1984); William K.S. Wang, *Some Arguments that the Stock Market Is Not Efficient*, 19 U.C. DAVIS L. REV. 341 (1986). *See also* Julie Rohrer, *Ferment in Academia*, INSTITUTIONAL INVESTOR, July 1985, at 79; George Anders, *Some "Efficient Market" Scholars Decide It's Possible to Beat the Averages After All*, WALL ST. J., Dec. 31, 1985, at 11. For an article questioning the extent to which pricing efficiency leads to allocative efficiency and suggesting therefore that the "current preoccupation with nurturing efficient stock market pricing seems unwarranted . . . [or] at least misdirected," see Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 707 (1988).

83. Under the "semistrong" form of the efficient market hypothesis, share price reflects all publicly available information, but does not reflect nonpublic information. Accordingly, those privy to inside information (such as corporate managers) should be able to assess a firm's value more accurately than the uninformed market. *See* John C. Coffee, Jr., *Liquidity Versus Control: The Institutional Investor as Corporate Monitor*, 91 COLUM. L. REV. 1277, 1330, n.206 (1991) [hereinafter *Liquidity Versus Control*]; *infra* notes 88-98 and accompanying text.

84. *See, e.g.*, Reinier Kraakman, *Discounted Share Price as a Source of Acquisition Gains, in* CORPORATE LAW AND ECONOMIC ANALYSIS 29, 36-37 & n.20 (Lucian Bebchuk ed., 1990); Gordon & Kornhauser, *supra* note 82, at 825-30; *see also* Gardner Ackley, *Commodities and Capital: Prices and Quantities*, 73 AM. ECON. REV. 1, 3-7, 12-14 (1983); Louis Lowenstein, *Management Buyouts*, 85 COLUM. L. REV. 730, 752-53 (1985); Robert J. Shiller, *Stock Prices and Social Dynamics*, BROOKINGS PAPERS ON ECON. ACTIVITY 457, 481-88 (1984); Wang, *supra* note 82, at 347-49.

One commentator has suggested that an *efficient* market is "one in which price is within a factor of two of value, i.e., the price is more than half of value and less than twice value . . . . By this definition, I think almost all markets are efficient almost all of the time. 'Almost all' means

view, share prices can be "poor estimates of the expected value of corporate assets."[85] Managers, defending against hostile takeovers, have long claimed that shares are undervalued by the market;[86] moreover, challenges to the market's fundamental-valuation efficiency increasingly appear in the literature.[87]

Indeed, there is reason to believe that the market may do a particularly poor job in pricing investments in long-term productive assets, such as research and development expenditures; and in a world of imperfect markets the dichotomy be-

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at least 90%." Fischer Black, *Noise*, 41 J. FIN. 529, 533 (1986) (presidential address to American Finance Association).

85. Kraakman, *supra* note 84, at 37.

86. Corporate executives, "feel themselves pushed in the short-sighted direction, against their own better judgment, by the fear that development and investment policies oriented toward the long term will be undervalued by the market and leave their firm vulnerable to takeover." MICHAEL L. DERTOUZOS ET AL., MADE IN AMERICA: REGAINING THE PRODUCTIVE EDGE 62 (1989) [hereinafter MADE IN AMERICA]. If the market undervalues shares, then even substantial premiums above market price may not give shareholders the intrinsic value of their shares. It has been suggested that the willingness of courts to sustain defensive tactics to hostile takeover bids, *see supra* notes 55-57 and accompanying text, implicitly acknowledges this undervaluation theory. *See* Wang, *supra* note 82, at 398-99 & n.182. For a discussion of managerial myopia in the face of discounted share prices, *see infra* notes 99-115 and accompanying text.

87. *See, e.g.*, Shiller, *supra* note 84, at 457; Robert J. Shiller, *Do Stock Prices Move Too Much to be Justified by Subsequent Changes in Dividends?*, 71 AM. ECON. REV. 421 (1981); Lawrence H. Summers, *Does the Stock Market Rationally Reflect Fundamental Values?*, 41 J. FIN. 591 (1986); *cf.* Andrei Shleifer & Robert W. Vishny, *The New Theory of the Firm: Equilibrium Short Horizons of Investors and Firms*, 80 AM. ECON. REV., 148, 148 (1990) (arbitrageurs trade "based on knowledge that the price of an asset is different from its fundamental value").

The economist John Maynard Keynes also questioned the "fundamental values" efficiency of the stock market, suggesting that stock prices really reflect predictions about future investor preferences rather than intrinsic share value. *See* JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 153-58 (1936) (investment in stock market resembles beauty contest competition, where competitors attempt to predict average preferences of other competitors, so that "each . . . pick[s] not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of other[s]"). *See also* Lowenstein, *supra* note 84, at 752-53 ("high turnover makes sense only if investors are paying a high degree of attention to what their fellow investors are about to do and to the short term expectations that motivate them, and paying less attention to asset values and other measures that would influence a buyer—or seller—of the business as a whole").

tween the short and long term becomes clearer. The most immediate problem is informational asymmetry.[88] Managers have access to non-public information about the firm's future plans and the likely yield on long-term investments.[89] Ideally, managers would disclose all of the information the market needs to know in order to price accurately the firm's shares. However, this information cannot be costlessly or readily disseminated to shareholders. Through public disclosures, managers risk revealing proprietary information to competitors.[90] Even were corporate managers prepared to assume the risk of benefitting their competitors by revealing proprietary information, the not unreasonable expectation of either private litigation or governmental enforcement actions under a variety of theories based on securities fraud (for either revealing too much or too little, too optimistically or too pessimistically or in violation of the insider trading prohibitions) would prove a powerful disincentive to such disclosure.[91]

One advantage of having financial intermediaries on the board (for example, bankers or professional directors selected by institutional investors)[92] is the possibility of conveying more complete information concerning innovative and promising, albeit risky or unconventional, long-term investments with less fear of breached confidences.[93] Nevertheless, such shareholders would still have to be willing to "accept some market penalty," during the period of confidentiality, when the market discounted management's agenda.[94] The short-term investment horizon of shareholders, including those of many insti-

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88. Admittedly, perfectly efficient markets could exist in a Panglossian world of cost-free access for all to all available information, a world without transaction costs, and where market participants share homogeneous expectations; however, the EMH "purports to make a strong statement where some of these conditions are not present." Gordon & Kornhauser, *supra* note 82, at 771.

89. *See, e.g.*, OLIVER E. WILLIAMSON, MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS 145-48 (1975) (managers have more complete access to intracorporate information, including information concerning investment proposals and strategies, than capital markets).

90. *See, e.g., Liquidity Versus Control, supra* note 83, at 1331.

91. *See infra* note 331 and accompanying text.

92. *See infra* notes 336-47, 374-84 and accompanying text.

93. *But see infra* notes 387, 392 and accompanying text for discussion of regulatory obstacles, including possible insider trading or lender liability provisions, to involvement in corporate governance by financial institutions.

94. *Liquidity Versus Control, supra* note 83, at 1332.

tutional investors, makes such a scenario unlikely.[95]

Accordingly, it has been suggested that because shareholders cannot observe the inner workings of the firm and must rely on imperfect financial summaries, a costly signaling process occurs. Managers may, for example, sell valuable assets or abort investment projects that have little effect on current earnings and are undervalued by shareholders. Such actions may boost earnings but, had a longer horizon permitted projected long-term yields to materialize, shareholders would in fact have obtained a far greater return on their investments.[96] The liquidity perspective of shareholders,[97] as exacerbated by takeover threats, fuels this myopic process.[98]

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95. For further discussion of the role of financial intermediaries, *see infra* notes 314-31, 374-94 and accompanying text.

96. *See* Jeremy C. Stein, *Takeover Threats and Managerial Myopia*, 96 J. POL. ECON. 61, 74-78 (1988); Jeremy C. Stein, *Efficient Capital Markets, Inefficient Firms: A Model of Myopic Corporate Behavior*, 104 Q.J. ECON. 655, 668 (1989) [hereinafter Stein, *Efficient Capital Markets*]; *see also Liquidity Versus Control*, *supra* note 83, at 1331-32; DUNCAN FOLEY & WILLIAM LAZONICK, CORPORATE TAKEOVERS AND THE GROWTH OF PRODUCTIVITY 3-4 (Dept. of Econ., Barnard College Working Paper No. 91-01, 1990); *cf.* LUCIAN ARYE BEBCHUCK & LARS A. STOLE, DO SHORT-TERM MANAGERIAL OBJECTIVES LEAD TO UNDER- OR OVER-INVESTMENT IN LONG-TERM PROJECTS? (Harvard Law School Program in Law and Economics Discussion Paper No. 87, 1991) (short-term managerial objectives may lead to underinvestment or over-investment in long-run projects, where the market has incomplete information).

Consider also the incentive structure of arbitrageurs, who trade "based on knowledge that the price of an asset is different from its fundamental value." Shleifer & Vishny, *supra* note 87, at 148. Arbitrageurs purchase assets that are underpriced in order to reap the profits when the "mispricing" disappears. Professors Shleifer and Vishny suggest that arbitrage in short-term assets is less expensive than arbitrage in long-term assets, and that long-term assets must be more mispriced in equilibrium than short-term assets for net returns to be equal. Arbitrageurs will, therefore, tend to "cluster[] on the trading of short-term assets." *Id.* at 153. This clustering will, in turn, lead to "systematically more accurate pricing of short-term assets than of long-term assets, even though efficient capital allocation and managerial evaluation might be better served by the opposite bias." *Id.*

97. *See infra* notes 117-30 and accompanying text.

98. *See* Stein, *supra* note 96, at 63 (if managers believed their shareholders were patient—"would not be discouraged by a low earnings report"—they would not act myopically out of fear that impatient shareholders will dump their shares, which would lower share price still further); Shleifer & Vishny, *supra* note 87, at 151 (managers may choose short-term over long-term investment projects since long-term projects

b. Reactions to Discounted Share Price

In an efficient market, it is presumed that shares trade at prices that "fully and accurately reflect the value of the firms'

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allow equity to be "more mispriced" and threaten their jobs); Coffee, *Shareholders Versus Managers*, *supra* note 18, at 63 (because the threat of takeovers is "constant and unrelenting," managers may divert their attention away from the long-term best interests of the corporation and instead focus on defensive tactics).

The account given above and in the text is sharply disputed. Certain event studies have investigated the immediate effect on stock prices of announcements of increases in research and development (R&D) spending and report positive price effects. *See, e.g.*, J. Randall Woolridge, *Competitive Decline and Corporate Restructuring: Is a Myopic Stock Market to Blame?*, 1 J. APPLIED CORP. FIN. 26, 33 (1988) (45 announcements, 30-day increase of 1.5%); John J. McConnell & Chris J. Muscarella, *Corporate Capital Expenditure Decisions and the Market Value of the Firm*, 14 J. FIN. ECON. 399, 419-20 (1985) (study of 658 capital expenditure announcements (including only eight announcements of changes in R&D expenditures) and reporting that increases/decreases in planned capital expenditures were associated with significant positive/negative share price effects).

The significance of these event studies should not be overstated. Although such studies report positive reactions to certain investment decisions, they prove nothing about the appropriateness of the magnitude of market movement relative to potential benefits. As Professor Bronwyn Hall, a leading researcher in the area, explains, these studies argue only against "*extreme* market myopia," but say nothing about whether the market's response is of the "right order of magnitude." BRONWYN H. HALL, THE IMPACT OF CORPORATE RESTRUCTURING ON INDUSTRIAL RESEARCH AND DEVELOPMENT 88 (National Bureau of Economic Research Working Paper No. 1476, 1990) (emphasis added) [hereinafter CORPORATE RESTRUCTURING]. Thus, if the share price increase is not sufficiently reflective of the expected present discount value of investment returns, the market may be discriminating against such investments. Moreover, these event studies typically involve small samples—*see, e.g.*, the extremely small sample of R&D announcements studied in McConnell & Muscarella, *supra*—which raise questions of statistical significance. *See* comments of F.M. Scherer in KNIGHTS, RAIDERS AND TARGETS: THE IMPACT OF THE HOSTILE TAKEOVER 27 (J. Coffee, Jr. et al. eds., 1988) (estimating that there are in any given year 20,000 R&D projects underway, but above noted studies typically concern only a small sample of formally announced projects). Furthermore, there may be a selectivity bias to these studies, for it seems reasonable to assume that where a firm decides to make a formal announcement of R&D expenditures (as opposed to the myriad decisions to implement R&D expenditures *not* formally announced), such announcements involve particularly promising and easily comprehensible research projects, and few costs in terms of tipping off competitors.

assets and expected earnings."[99] There should be few "bargains" because traders will bid the price up to, but theoretically not higher than, its true value.[100] However, the last fifteen years have witnessed corporate takeovers in which enormous premiums above market price were offered for shares.[101] To these raiders at least, the shares did not reflect the true value of the underlying assets.[102] These discounts in share price are believed to reflect what Professor Kraakman terms the mana-

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99. Stout, *supra* note 81, at 1235; Kraakman, *supra* note 84, at 29-30. Despite the theoretical connection between share price and underlying asset values, share prices for certain corporations frequently fall below market value for underlying assets—e.g., closed-end investment funds, holding companies and natural resource firms. *See, e.g.*, Burton G. Malkiel, *The Valuation of Closed-End Investment—Company Shares*, 32 J. FIN. 847 (1977); Rex Thompson, *The Information Content of Discounts and Premiums on Closed-End Fund Shares*, 6 J. FIN. ECON. 151 (1978). Since, as Professor Kraakman points out, these are corporations whose underlying assets are, if anything, more visible than other corporations, it seems unlikely that they are "anomalous" as often described. It seems reasonable to infer that such discounts are not in fact anomalies but rather that security prices frequently discount expected cash flows from corporate assets. Kraakman, *supra* note 84, at 29-30. "[W]hy suppose that discounts perversely exist only where they can be seen and nowhere else?" *Id.* at 46.

100. *See* Ravenscraft & Scherer, *supra* note 20, at 37. Thus, in an "efficient" market, takeovers should not typically be motivated by the belief that shares are undervalued, although, as the authors explain, raiders might (wrongly) believe shares were undervalued and pursue the takeover anyway. *Id.* Moreover, certain definitions of "efficiency" encompass a fairly wide range of values—e.g., price within a factor of two of value, Black, *supra* note 84, at 533—which would permit substantial gains to be made by those who located undervalued securities even in an efficient market. *Id.*

101. *See, e.g.*, Bernard S. Black, *Bidder Overpayment in Takeovers*, 41 STAN. L. REV. 597, 601 (1989) (premiums averaging 50% above market in 1980s); Reinier Kraakman, *Taking Discounts Seriously: The Implications of 'Discounted' Share Prices as an Acquisition Motive*, 88 COLUM. L. REV. 891, 892 (1988) (premiums averaging 50% above market). Indeed, one of the perceived strengths of the takeover is its ability to narrow the gap between share price and asset value for individual shareholders. *See, e.g.*, Kraakman, *supra* note 84, at 69 n.130 ("takeovers arbitrage between asset and securities markets [thereby correcting] share prices").

102. *See* Kraakman, *supra* note 101, at 891-908; Kraakman, *supra* note 84, at 40-46. Although it has been noted that the discount in share price begins to narrow or disappear during "long-term bull markets," Professor Kraakman observes that their demise has proven greatly exaggerated. *Id.* at 41 n.34.

gerial "misinvestment" hypothesis.[103]

Managers, so the theory goes, frequently misuse their power to direct "free cash flow."[104] They fail to reallocate resources to their most productive uses (which may be outside the corporation that generated the cash flow),[105] retaining surplus rather than distributing it to shareholders or profitably investing it. There are various explanations offered for this behavior, including managers' fundamental risk-aversion[106] or self-interested desire for corporate growth (i.e., prestige, compensation, etc.).[107] Whatever the reasons, shareholders will discount

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103. Kraakman, *supra* note 84, at 30, 35-36.

104. *See* Michael C. Jensen, *Agency Costs of Free Cash Flows, Corporate Finance, and Takeovers*, 76 AM. ECON. REV. (PAPERS AND PROCEEDINGS), May 1986, at 323 [hereinafter Jensen, *Free Cash Flows*]; Jensen, *Eclipse*, *supra* note 5, at 66-67; *see also* Frank H. Easterbrook, *Two Agency-Cost Explanations of Dividends*, 74 AM. ECON. REV. 650, 652-54 (1984) (the interests of averse managers, who are not the residual claimants of the firm's income, may diverge from the interests of other participants in the corporate venture); Coffee, *Shareholders Versus Managers*, *supra* note 18, at 16-24 (discussing how a manager's overinvestment in the firm leads to less diversified portfolios than individuals' or institutional investors' portfolios).

105. *But see* FOLEY & LAZONICK, *supra* note 96, at 1 (such criticisms "contain no theory of the firm as an innovator that, through the development and utilization of the productive resources at its disposal, can generate economic outcomes superior to those reached through a purely market-directed process").

106. Unlike shareholders, who can minimize risk through a diversified investment portfolio, managers are overinvested in one enterprise. Indeed, one explanation for the "conglomeration" boom of the 1960s and 1970s suggests that risk-aversion led managers to create "diversified portfolio[s] within their firms." Coffee, *Shareholders Versus Managers*, *supra* note 18, at 20. *See id.* at 16-24; Yakov Amihud & Baruch Lev, *Risk Reduction As A Managerial Motive for Conglomerate Mergers*, 12 BELL J. ECON. 605 (1981) (stating that conglomeration is more likely in manager-controlled firms than in owner-controlled firms); *see also* Note, *The Conflict Between Managers and Shareholders in Diversifying Acquisitions: A Portfolio Theory Approach*, 88 YALE L.J. 1238, 1243 (1979) (stating that diversification internally or through acquisition reduces a manager's risk). *But see* Jerome B. Cohen, *Some Economic Aspects of Conglomerate Mergers*, *in* CONGLOMERATES AND CONGENERICS 45, 51 (1970) (finding that conglomerate acquisitions were financially motivated because "[a]ny time a company buys another [with] a lower price-earnings ratio, earnings per share of the merged company will inevitably be higher than those of the acquiring company in the previous year").

107. *See* Jensen, *Free Cash Flows*, *supra* note 104, at 323; Jensen, *Eclipse*, *supra* note 5, at 66. *But see* FOLEY & LAZONICK, *supra* note 96, at 34-35 (self-interest will prompt managers to pursue innovative strate-

corporate share prices accordingly when managers engage in such behavior. Under this explanation, hostile takeovers involving substantial premiums[108] for shares punish wasteful,[109] "overly risk-averse"[110] or self-interested managers and liberate this cash flow (as well as redeploying the underlying assets) for productive investment.[111]

If the market, however, is doing a poorer job of pricing shares than is commonly presumed (in part because it inaccurately prices long-term capital returns), then takeovers may be occurring even in corporations that are efficiently managed.[112] This might justify a different range of regulatory responses than would be appropriate if the market were perfectly efficient at fundamental valuation and the pricing of investments in long-term productive assets, and managers were simply misinvesting.[113] Indeed, if well-managed corporations are at risk of takeover because of unwarranted share price discounts,

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gies to ensure competitive advantage for their firm).

108. Another explanation has been offered for the takeover premium: price pressure. Where bidders "corner the market" for shares, the process of buying up larger and larger quantities of stock "should inevitably bid up the market price." Stout, *supra* note 81, at 1236.

109. *See, e.g.*, Jensen, *Free Cash Flows*, *supra* note 104, at 328 (stating that reductions in investment, *inter alia*, following hostile takeovers and leveraged buyouts eliminate inefficient investment by corporate management). *But see* Shleifer & Vishny, *supra* note 87, at 152 (suggesting that some cuts in investment eliminate good long-term projects that were responsible for market underpricing).

110. Coffee, *Shareholders Versus Managers*, *supra* note 18, at 27.

111. *See also* Joseph A. Grundfest, *Subordination of American Capital*, 27 J. FIN. ECON. 89, 89 n.20 (1990) (in an economy with high costs of capital, free cash flow may prompt hostile takeovers, as corporations seek to control valuable capital); *infra* notes 185-201 and accompanying text.

112. *See* Kraakman, *supra* note 84, at 68; *see also* Warren E. Buffett, et al., *Hostile Takeovers and Junk Bond Financing: A Panel Discussion*, *in* KNIGHTS RAIDERS AND TARGETS, *supra* note 98, at 11, 13 [hereinafter Buffett Remarks] (remarks of panelist Warren E. Buffett):

> [O]ver a good many of [the past] 44 years and a good many of the past 10 years, the very best managed companies I know of have very frequently sold in the market at substantial discounts from what they were worth that day on a negotiated basis. It isn't just the weak managements or the companies that are not meeting their potential that are vulnerable to takeovers because of market disparities from negotiated business value.

Id.

113. *See, e.g.*, Kraakman, *supra* note 84, at 64-71; Stout, *supra* note 81, at 1284-95.

even managers of corporations not targets of actual or threatened takeovers may act myopically[114] in a defensive effort to narrow that discount.[115] In an atmosphere of "revolving-door ownership"[116] managers may be tempted to raise share price any way they can, even by forgoing research and development programs or excessively leveraging the firm, to the detriment of its long-term performance.

2. Shareholder Myopia: The Liquidity Perspective.

Shareholders of public corporations purchase ownership interests in a business enterprise,[117] but they neither wish to

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114. For Professor Jensen, myopic behavior by managers will occur when they are not adequately concerned with share price because their compensation is keyed to accounting earnings rather than share price. *See* Jensen, *supra* note 3, at 10-11. A reform of managerial compensation in the direction Jensen suggested is certainly desirable. However, if, as Jeremy Stein suggests, managers may engage in inefficient decisionmaking because they are overly concerned about current share prices, see Stein, *Efficient Capital Markets*, *supra* note 96, at 656, it is difficult to understand why making managers *more* attentive to current share price mitigates the tendency to myopic behavior. Stein's diagnosis argues for measures to ensure that managers remain long-term shareholders. For a discussion on reform of executive compensation, see *infra* notes 395-413 and accompanying text.

115. The spillover or demonstration effects of takeover pressures on firms that are not yet targets of hostile bids complicate attempts to draw conclusions from empirical research. Empirical studies essentially compare the R&D spending levels of companies involved in mergers or takeovers with spending levels of companies *not* so involved. However, the fact that "both groups may have declined and there may be no obvious difference between the two groups that is evident after the decline," ACADEMY INDUSTRY PROGRAM, CORPORATE RESTRUCTURING AND INDUSTRIAL RESEARCH AND DEVELOPMENT 84-85 (1990) [hereinafter NAS, CORPORATE RESTRUCTURING] (remarks of Kenneth S. Flamm), is consistent with an hypothesis of demonstration effects. Indeed, proponents of takeovers credit the demonstration effect of hostile bids (the "self-raiding" to avoid a takeover) with achieving much of the efficiency gains (decreased agency costs) of the takeover era. *See, e.g.* Easterbrook & Fischel, *supra* note 3, at 1169-73 (discussing the influence of the bidding process on agency costs).

116. *See* Buffett Remarks, *supra* note 112, at 14. Professor Coffee has emphasized the undesirable effects of the "constant and unrelenting" threat of takeovers on managerial decisionmaking. *See* Coffee, *Shareholders Versus Managers*, *supra* note 18, at 63. One possible technique for addressing this concern would be "takeover windows" at spaced intervals, written into corporate charters. *See id.* at 63 n.175; Martin Lipton & Steven A. Rosenblum, *A New System of Corporate Governance: The Quinquennial Election of Directors*, 58 U. CHI. L. REV. 187, 225-26, 240-45 (1991), discussed *infra* note 272.

117. The bulk of public shareholding today consists of institutional

operate that business nor do they act like its owners.[118] They invest in securities precisely because they do not choose to become owners of some other, less liquid investment property.[119] Unlike owners of businesses, owners of corporate securities tend to have a transient relationship to the underlying business.[120] They do not feel an owner's commitment to the corporation and, if they believe management is performing poorly,[121] they typically sell their shares rather than attempt to

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investors. *See, e.g.*, NEW YORK STOCK EXCHANGE, 1990 SURVEY OF SHAREOWNERSHIP (reporting, *inter alia*, that there are over 25 million mutual-fund holders, and investment companies manage almost $1.5 trillion in assets). Although institutional investors frequently purchase large blocks of shares (as compared to the decreasing pool of individual shareholders), they still own relatively small percentages of any single corporation. Moreover, our system of regulating financial institutions prevents such institutions from increasing their equity positions to the point of acquiring control. *See, e.g.*, Mark J. Roe, *A Political Theory of American Corporate Finance*, 91 COLUM. L. REV. 10, 11 (1991). *See infra* notes 218-20, 317-23 and accompanying text.

118. *See, e.g.*, Lowenstein, *supra* note 3, at xii ("[S]hareholders have increasingly come to think of their stocks as a financial commodity, something divorced from the underlying business, assets to be traded rather than investments to be owned.").

119. *See* FRED E. BALDWIN, CONFLICTING INTERESTS 38 (1984) (suggesting that the nature of property affects the attitude and relationship of owners to that property and concluding that shareholders, as owners of liquid property, feel less responsibility for actual business).

120. Compare Berle & Means' description of the orientation of the owner of non-liquid property:

> The owner of non-liquid property is, in a sense, married to it. It contributes certain factors to his life, and enters into the fixed perspective of his landscape. If [the property is a business] he lives with it, works at it, builds his life at least partly around it with an agent . . . devised to run it in his absence. These are the bases of association and interests, of desires, ambitions, fears, troubles. At the same time, the quality of responsibility is always present . . . . [T]o translate property into liquid form the first requisite is that it demand as little as possible of its owner . . . . The separation of ownership from management and control in the corporate system has performed this essential step in securing liquidity.

Berle & Means, *supra* note 2, at 284-85.

There are, of course, exceptions to this rule. *See, e.g.*, Ron Suskind, *Legend Revisited: Warren Buffett's Aura as Folksy Sage Masks Tough, Polished Man*, WALL. ST. J., Nov. 8. 1991, at A1 (depicting Buffett as the "standard bearer for long-term investing and the perfect antidote to the get-rich-quick schemers of Wall Street").

121. Moreover, they measure the adequacy of management perfor-

intervene.[122]

Shareholder passivity, then, so troubling to commentators and theorists,[123] in large part reflects the reality of what shareholders do and do not *choose* to invest in:[124] they "own" an entitlement to an income stream (dividends, when and if declared by the board of directors) and they "own" any appreciation (or loss) in the value of their shares on the resale market. This ownership interest is typically part of a diversified portfolio of equally liquid investment securities. Shareholders do not directly own or control the disposition of the decidedly non-liquid underlying assets of the corporation nor direct corporate employees in the way the proprietor of a grocery shop owns her inventory and equipment and directs her clerks. Public shareholders, unlike bona fide entrepreneurs, thus tend to share a distinctly "liquid" perspective concerning the contents of their investment portfolios. With some qualification, institutional investors also share a similar perspective.[125]

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mance by short-term performance gains. *See infra* notes 326-30 and accompanying text.

122. *See* Gilson & Kraakman, *Outside Director*, *supra* note 10, at 886-90 (suggesting that selection of professional outside directors through a clearinghouse may help overcome the collective action problem); *infra* notes 348-49 and accompanying text. Given problems of free riding and collective goods, the shareholders' liquidity perspective is both rational and predictable. All shareholders benefit from the collective good of active, responsible (and costly) monitoring of management. However, although the monitor-shareholders cannot capture all of the benefits of their monitoring, they do bear all of the costs. Economically "rational" shareholders will prefer to let others monitor for them—to free ride when corporate performance is satisfactory, and to sell (rather than monitor) when it is not.

123. *See* sources cited in *supra* note 10; Grundfest, *supra* note 111 (discussing the inability of investors to monitor management and control assets).

124. *See* Henry K. Manne, *The "Higher" Criticism of The Modern Corporation*, 62 COLUM. L. REV. 399, 402 (1962) (investor is risk-taker, having no desire to control business, who purchases future income stream). The difference between purchasing stock, bonds or any other property is "more one of acceptable risk and potential profitability than it is a question of control or lack of it." *Id.* at 406.

125. It is an oversimplification to paint all shareholders with the same "short-term" brush. *See infra* notes 325-31 and accompanying text. Indeed, some institutional investors may have a more long-term perspective because their large holdings are relatively less "liquid," i.e., the act of disinvesting may itself affect price negatively. However, fund managers still lack "long-term loyalty" to corporations and rapidly turn over their portfolio holdings in an effort to maximize their current value "since this

The "liquidity" perspective,[126] however beneficial to the formation and growth of a capital market system, tends to focus public investors on the short term—on this quarter's earnings profile, on today's share price. Shareholders can rationally conclude that (by trading) they capture the benefit of any managerial decisions that drive the share price up on a given day.[127] If that price increase results, for example, from short-sighted failures to make adequate investments in research and development or other long-term capital assets such as a well-trained and educated workforce,[128] the future cost in terms of decreasing productivity and competitiveness will fall on someone (indeed, everyone) else. Short-term decisionmaking will have lasting deleterious effects on the corporation and the economy if managers increasingly decide to forego long-term investments in favor of short-term financial shareholder gains.[129] Such a perspective would be unwise for the owner of

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is the main criterion against which their own performance is judged." MADE IN AMERICA, *supra* note 86, at 62. *See Liquidity Versus Control*, *supra* note 83, at 1325 nn.194-95, 1326 (noting that professional money managers' performance is reviewed monthly or quarterly, leading them to adopt short-term performance objectives and to avoid costs that "do not affect their current competitive standing vis-a-vis their peers"); *Pensionforum: Dismay Over Short-termism*, INSTITUTIONAL INVESTOR, Mar. 1991, at 139, 139 (over 90% of pension funds review performance of outside money managers at least quarterly; only 5.6% review performance semiannually; 3% review performance annually); Lipton & Rosenblum, *supra* note 116, at 207 (citing authorities).

126. Professor Shubik refers to the "mass, anonymous liquid market for the exchange of financial paper." Martin Shubik, *Corporate Control, Efficient Markets, and the Public Good, in* KNIGHTS, RAIDERS AND TARGETS, *supra* note 98, at 31, 45.

127. *Cf. Liquidity Versus Control*, *supra* note 83, at 1327 & nn.200-01 (shareholders often accept disfavored managerial proposals, e.g., antitakeover proposals, when linked to "sweeteners" such as large dividends or stock repurchases because they expect to receive the gain and then sell their shares).

128. *See infra* notes 151-58 and accompanying text.

129. *See, e.g.*, findings recited in Senator Sanford's recent bill, entitled the "Long-Term, Investment, Competitiveness, Pension Protection and Corporate Takeover Reform Act of 1991." S. 1679, 102d Cong., 1st Sess. (1991) (stating that the current short-term focus, arising partially from the takeover environment, leads to lack of R&D investment and increased debt and is contrary to America's need to maintain worldwide competitive position and economy); MADE IN AMERICA, *supra* note 86, at 62. For a discussion of the empirical literature concerning, e.g., R&D spending, see *infra* notes 157-84 and accompanying text.

a shop or manufacturing firm, given the relative non-liquidity of businesses as opposed to stocks. It is also unwise for a national economy that relies on private firms to make investments in long-term productive capacity,[130] despite the rationality of individual shareholders' decisions and possible short-term increases in personal wealth.

3. Effects of Shareholder and Managerial Myopia

a. Excessive Leveraging

It is universally conceded that there has been a dramatic increase in indebtedness in the United States both for the nation as a whole, and within public corporations.[131] Much of the responsibility for this shift toward debt[132] has been charged to a system of tax laws[133] that creates financial incentives to choose debt over equity; interest payments are deductible while dividend payments are not.[134] (Indeed, the

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130. *See* MADE IN AMERICA, *supra* note 86, at 10; *infra* notes 151-84 and accompanying text.

131. Combined borrowings of nonfinancial institutions neared $2 trillion in 1988, increased from $835 billion in 1979. *See* Jensen, *Eclipse*, *supra* note 5, at 67 (citing Federal Reserve Board, Balance Sheets of U.S. Economy).

132. *See supra* note 4; Roberta S. Karmel, *Is It Time for a Federal Corporation Law?*, 57 BROOK. L. REV. 55, 70-71 & nn.94-95 (1991) (ratio of nonfinancial corporate debt to nonfinancial corporate gross domestic product rose from 52% in 1982 to over 67% by end of 1988); John Floegel, Note, *Equity Financing for Public Corporations: Reasons and Methods to Encourage It*, 138 U. PA. L. REV. 1411, 1412 n.5 (1990) (debt of nonfinancial corporations in United States increased by $840 billion; equity decreased by $300 billion; interest on the debt incurred in recent takeovers equals 26% of internal cash flow (all-time high)); Henry Kaufman, *Halting the Leverage Binge*, INSTITUTIONAL INVESTOR, Apr. 1989, at 23, 23 (comparing 15.4% annual growth in debt to 8.4% average annual growth in debt over previous six economic cycles). The tide seems to have turned somewhat recently, however, as corporations have begun increasingly to make public equity offerings.

133. *See, e.g.*, CORPORATE RESTRUCTURING, *supra* note 98, at 123 n.56; Lipton, *supra* note 3, at 9-11.

134. *But see* Franco Modigliani & Merton H. Miller, *The Cost of Capital, Corporation Finance and the Theory of Investment*, 48 AM. ECON. REV. 261 (1958). The Modigliani and Miller theory suggests that the cost of capital ought to be (in fact is) independent of capital structure. The thesis depends, however, on certain important, controversial assumptions including the existence of perfect capital markets, where information is costless and available for all investors; zero transaction costs; firms that are classifiable into "equivalent return" groupings within which all have

overall effect of the various tax reforms of the early 1980s, it is claimed, has been to make debt capital one-half as expensive as equity capital.)[135] It is, then, economically rational for corporations to prefer maximum leverage short of an unacceptable risk of bankruptcy.[136]

Whereas corporations have always borrowed in order to invest in positive net present value (NPV) assets, recently corporate raiders and corporations have been aggressively

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the same degree of business risk; and the absence of corporate income tax. *See* J.C. VAN HORNE, FINANCIAL MANAGEMENT AND POLICY 239-50 (4th ed. 1977). Van Horne explains, however, that the picture changes somewhat when we introduce factors like corporate taxes and bankruptcy costs and indeed is "on weaker ground" when leverage is extreme. *Id.* at 243. Since interest payments are deductible to the corporation, "leverage lowers the weighted-average after-tax cost of capital [even under the Modigliani & Miller theory]." Thus, corporations can in fact lower the cost of capital by increasing leverage until they reach a point of extreme leverage where the combination of leverage costs and bankruptcy costs causes the cost of capital to begin to rise again. *Id.*

135. CORPORATE RESTRUCTURING, *supra* note 98, at 123 n.56; *see generally* Katherine Schipper & Abbie Smith, *Effects of Management Buyouts on Corporate Interest and Depreciation Tax Deductions*, 34 J.L. & ECON. 295 (1991) (cited in HALL, INVESTMENT HORIZONS); Myron S. Scholes & Mark A. Wolfson, *The Effects of Changes in Tax Laws on Corporate Reorganization Activity*, 63 J. BUS. L. 141 (1990).

For a discussion of the impact of the Tax Reform Act of 1986 on R&D spending in the United States, see JAMES R. HINES, JR., ON THE SENSITIVITY OF R&D TO DELICATE TAX CHANGES: THE BEHAVIOR OF U.S. MULTINATIONALS IN THE 1980S, (National Bureau of Economic Research Working Paper No. 3930, 1991).

136. Increased leveraging of U.S. corporations has increased the risk of bankruptcy. *See infra* notes 247, 305-09 and accompanying text. Although U.S. corporations remain less highly leveraged (in terms of debt-to-equity ratios) than their average Japanese and German counterparts, their risk of financial distress is considerably greater in part because of the policy of governmental non-intervention and the lack of stable and intense corporate debtor-creditor relationships such as those that prevail in Japan and Germany. *See infra* notes 202-42 and accompanying text. In addition, the relatively higher interest rates in the U.S., which contributed to the relatively higher cost of capital for U.S. corporations, have also increased financial risk. *See infra* notes 185-201 and accompanying text (cost of capital). The situation in Japan may be changing. *See* Clay Chandler, *Basically Sound: It's Hit a Rough Patch, But Japan's Economy Is Still Enviably Robust*, WALL ST. J., Mar. 23, 1992, at A1 (noting that although Japanese corporate profits are falling and the rate of bankruptcies is mounting, unemployment remains at just over two percent, inflation at well under three percent and there hasn't been a Japanese bank failure "since World War II").

borrowing to finance hostile takeovers and defensive corporate restructurings,[137] as well as to satisfy demands for high rates of return by institutional investors.[138] Corporations borrowed funds which were distributed to shareholders as dividends, share repurchases or takeover premiums.[139] As one commentator recently observed, "[t]he net effect was the opposite of capital formation: it was a liquidation of industry."[140]

Some commentators see this increase in corporate leveraging as a valuable efficiency enhancing mechanism.[141] Professor Jensen, for example, suggests that LBOs (indeed, increased indebtedness generally) have generated "remarkable gains in operating efficiency, employee productivity, and shareholder

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137. Much of this debt was incurred by companies and individuals engaged in making acquisitions. *See* HALL, INVESTMENT HORIZONS, *supra* note 6, at 6-7. Additional debt was undertaken defensively, by managers intent on preventing unwanted takeovers. Moreover, if high debt levels were believed to succeed in fending off hostile takeovers, no doubt other corporations which were not the targets of an immediate takeover threat engaged in similar tactics. For a discussion of demonstration effects, see *supra* note 115.

138. *See* Karmel, *supra* note 132, at 70. Debt issues have exceeded net equity issues by American nonfinancial corporations in every year since 1984. *See* Alan J. Auerbach, *Tax Policy and Corporate Borrowing*, *in* PROCEEDINGS OF A CONFERENCE: ARE THE DISTINCTIONS BETWEEN DEBT AND EQUITY DISAPPEARING? 136 (R. Kopcke & E. Rosengren eds. 1989).

139. *Id.*

140. *Id.* Moreover, the enormous transaction costs generated by these restructurings "siphoned money from our industrial base into investment banking and attorney fees." *Id.*

141. It has been suggested that the increased risk of bankruptcy in highly leveraged firms is a strength of leveraging rather than a weakness. Since even relatively minor decreases in cash flow may trigger default on existing debt service, bankruptcy is likely to occur at a relatively early point in a firm's downward spiral, preserving substantial assets for creditors. *See* Jensen, *Eclipse*, *supra* note 5, at 67. Unfortunately, however, the risk of financial failure for U.S. corporations accounts in part for the uncompetitively high cost of capital. Investors, well aware of the low probability of government bailout or rescue by creditors outside of the costly bankruptcy system, demand *ex ante* risk premiums that raise capital costs far above those enjoyed by competitor corporations in Japan and Germany. *See infra* notes 224-27, 305-06 and accompanying text. *But cf.* Patrick A. Murphy, *Plans Can Succeed, Sometimes*, NAT'L L.J., Apr. 15, 1991, at 19 (discussing recent increase in use of "prepackaged" Chapter 11 bankruptcy plans by highly leveraged corporate debtors, whereby time spent in costly bankruptcy proceedings is substantially reduced and "going-concern value of the business . . . arguably . . . preserved").

value"[142] because "debt creation *without retention of the proceeds of the issue*" will limit managers' ability to retain earnings.[143] At the same time, however, this increased corporate debt load may result in underinvestment in long-term, often initially low-return investments.[144] One important area for such concern is corporate R&D spending.[145]

Although it seems unlikely that takeovers or changes of control per se necessarily result in decreased R&D spending, it has recently been established that there is a demonstrable "link between leverage and reduced R&D spending."[146] Indeed, the recent increase in highly leveraged takeover-related restructuring seems directly connected to a substantial decline in R&D growth in affected corporations.[147] Levels of post-re-

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142. Jensen, *Eclipse*, *supra* note 5, at 61-62. For further discussion of leveraged buyouts, see *infra* notes 296-313 and accompanying text.

There is debate in the literature over whether hostile takeovers, including highly leveraged takeovers, are value-creating or value-transferring transactions. *Compare, e.g.*, Andrei Shleifer & Lawrence H. Summers, *Breach of Trust in Hostile Takeovers*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 34, 53 (Alan J. Auerbach ed., 1988) (suggesting that some takeovers involve redistribution of value from stakeholders to shareholders, rather than the creation of new value), *with* Michael C. Jensen, *Takeovers: Folklore and Science*, HARV. BUS. REV. 109, 112-15 (Nov.-Dec. 1984) (increases in target share price indicate greater efficiency of merged corporations).

143. Jensen, *Eclipse*, *supra* note 5, at 67 (emphasis in original) ("[d]ebt is in effect a substitute for dividends"). *But see* FOLEY & LAZONICK, *supra* note 96, at 19 (retained earnings and depreciation reserves disgorged in the 1980s constitute "the financial foundations for long-term investment strategies"). Acknowledging that empirical research has not yet been undertaken concerning the reallocation of this disgorged "free cash flow," Professors Foley and Lazonick suggest that some of it may well have "flowed abroad [and that] such alternative uses of resources may increase the social welfare of Americans in the short run while, by undermining domestic innovation, contributing to a decline in their social welfare in the long run." *Id.* at 25.

144. *See, e.g.*, HALL, INVESTMENT HORIZONS, *supra* note 6, at 23; FOLEY & LAZONICK, *supra* note 96, at 19.

145. For discussion of the empirical data concerning R&D spending levels in the era of "leveraging," see *supra* note 6; *infra* notes 146-48, 156-63 and accompanying text.

146. CORPORATE RESTRUCTURING, *supra* note 98, at 123; *see also* HALL, INVESTMENT HORIZONS, *supra* note 6, at 7-9.

147. For example, during the Owens-Corning defensive restructuring in 1986, the firm reduced its workforce from 28,000 to 15,000. *See* Robert O'Brien & Richard Kline, *An Rx for Jobs Lost Through Mergers*, N.Y.

structuring debt have sometimes been so high that virtually all available cash flow must be used to service that debt.[148] Little or no cash may be available for seemingly discretionary investment (such as R&D research) without recourse to additional outside financing.

In a world of allocationally efficient markets and perfect information, the need to resort to external financing would raise no concerns because it would be possible to identify with confidence any positive NPV research project. Such a project would attract adequate funding from rational investors. Unfortunately, there is reason to doubt both assumptions. The market, whatever its efficiency in valuing financial assets, may be considerably less efficient at valuing real assets.[149] Moreover, as discussed above, there are significant informational asymmetries between managers and the market.[150] It is therefore impossible to conclude with confidence that all the "good" investment projects are still being undertaken and investment levels have decreased only because the "bad" (or redundant) projects are unable to obtain financing.

b. Diminished Investment Levels

It is widely conceded and deplored that the United States has increasingly lost competitive ground to other industrial nations.[151] There is alarming underinvestment in long-term

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TIMES, Feb. 22, 1987, § 4, at 23. These reductions included cutting R&D spending in half and firing 480 research employees. *See* Jack Willoughby, *What a Raider Hath Wrought*, FORBES, Mar. 23, 1987, at 56. For anecdotal accounts of the effects of LBOs on R&D spending, see *LBOs: Friend or Foe of Industrial Research?*, RES. & DEV. Apr. 1989, at 13; *What are LBOs Doing to R&D?*, CHEM. WK., Feb. 15, 1989, at 26 (citing a National Science Foundation survey finding decreased R&D spending with increased LBOs and other restructurings); Lester C. Thurow, *US Can't Compete if Finance Continues as the Master of Industry*, L.A. TIMES, Nov. 17, 1985, Pt. 5, at 3 (arguing that the debt load from LBOs reduces the funds available for R&D). Again, the effects are felt within the target and acquiring firms themselves, but demonstration effects resonate in other corporations as well. *See supra* note 115.

148. *See supra* notes 146-47 and accompanying text.

149. *See supra* notes 76-98 and accompanying text.

150. *See supra* notes 88-91 and accompanying text.

151. The MIT Commission on Productivity conducted detailed studies of eight manufacturing sectors of the economy: automobiles, chemicals, commercial aircraft, computers-semiconductors-copiers, consumer electronics, machine tools, steel, and textiles, and compared performance in these industries with competitors abroad. MADE IN AMERICA, *supra* note 86.

productive assets,[152] and our "stock of knowledge capi-

"The verdict is that American industry indeed shows worrisome signs of weakness. In many important sectors of the economy, U.S. firms are losing ground to their competitors abroad." *Id.* at 8.

152. *See, e.g.*; Lucinda Harper, *U.S. Businesses Trim Capital Spending Plans*, WALL ST. J., Sept. 6, 1991, at A2 (Commerce Department survey reports that companies plan a "tiny 0.5% increase in capital spending [including new plants and equipment] in 1991, the smallest increase in five years," after-tax profits in the April-June 1991 quarter were at the lowest level since 1989 and "[p]rofitability is a major determinant in capital spending" (quoting Robert Diehl, domestic economist for Northern Trust Co.)). The percentage of gross national product set aside for capital investment in the United States over the last twenty years (10%) has lagged far behind that of competitor nations like Japan (approximately 33%) and West Germany (20%). *See* Irwin L. Kellner, *Times Board of Economists: Investment is Path to Productivity*, L.A. TIMES, June 18, 1989, § 4, at 2. Indeed, the national rate of investment in plant and equipment has been lower in the 1980s than that of any sustained period since World War II. *Id. See* Ralph Landau & George N. Hatsopoulos, *Capital Formation in the United States and Japan*, *in* THE POSITIVE SUM STRATEGY 583, 590-91 & fig. 1 (Ralph Landau & Nathan Rosenberg eds., 1986) (Japanese investment in manufacturing sector is at two to two and one-half times U.S. rate of investment in capital per worker). Moreover, the decline in the rate of capital spending shows little sign of reversal. *See, e.g.*, Louis Uchitelle, *Capital Spending Unlikely to Surge*, N.Y. TIMES, Mar. 24, 1992, at D2 (net new investment, i.e., capital expenditures beyond cost of replacing existing equipment, has declined to less than five percent GDP as firms seek higher profits from existing operations rather than expanding in hopes of increasing market share).

Current productivity of non-agricultural workers also lags behind the earlier anticipated growth rate of 1.9% at a 0.5% seasonally adjusted annual rate. Harper, *supra*. *See* BENJAMIN M. FRIEDMAN, DAY OF RECKONING 7, 207 (1988) (since 1979, overall productivity growth in non-farm sector averaged just 1.1% per year). The comparative figures concerning manufacturing labor productivity are indeed discouraging. The U.S. increase in manufacturing labor productivity from 1989 to 1990 was 2.5%, lagging behind Japan (3%) and West Germany (4%). BUREAU LAB. STAT., U.S. DEP'T. OF LABOR, RELEASE NO. 91-406, at 1-2 (Aug. 20, 1991). Moreover, the U.S. gain resulted from a 2.0% decline in labor input (measured by hours worked) and only a 0.4% increase in manufacturing output. *Id.* By contrast, the gains in Japan and Germany reflected output gains of 4.5% and 5%, respectively, accompanied by smaller increases in labor hours. *Id.* The decrease in productivity gains began in the late sixties, but accelerated during the late 1970s. In addition, the United States' productivity growth increasingly lags behind other industrial nations. Although it is impossible to assign blame for lagging productivity to any one factor, our lagging national productivity rate coincides with our declining national investment rate when compared to the investment rates of competitor nations. *See* FRIEDMAN, *supra*, at 187-208.

tal"[153]—arguably as important for competitive industrial success as physical capital,[154] although not readily "inventoried by accountants or valued by appraisers"[155]—is also at risk.

For our stagnant economic growth rate to improve, we must increase the rate of "technical change"[156] through R&D investment and improve the quality of our labor force (human capital) through training and education. Unfortunately, we are failing to do either. There has been a disturbing decrease in long-term capital investment in general and in the growth of aggregate corporate R&D spending since the mid 1980s in particular.[157] Moreover, the United States educational system

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The MIT Commission on Industrial Productivity describes the process whereby "American industry lost its dominant position" in the semiconductor-computer-copier industry (where U.S. has dropped from 60% to 40% of market share in one decade) in part as follows. When product demand began to fall, many small American microelectronics firms decided to forego investment in order to maintain profit margins. During this period of decreased demand, Japanese companies (which had sometimes purchased proprietary knowledge from the American firms) increased their plant capacity and were ready to begin production when the next cycle of recovery began. By the time American firms began expanding their capacity again, it was too late. Profits generated from these too-little, too-late efforts were inadequate to finance the next generation of industrial plants and "[t]he contest was between small, single-product, inexperienced, under-financed American start-ups and the heavyweights of Japanese industry. David did not defeat Goliath." *Made in America*, *supra* note 86, at 10.

153. *See* Joseph A. Grundfest, Keynote Address at The National Academy of Sciences' Symposium on Corporate Restructuring and Industrial Research (Oct. 11, 1989), *in* NAS, CORPORATE RESTRUCTURING, *supra* note 115, at 4 [hereinafter Grundfest Remarks]. This knowledge capital consists of technical expertise, trade secrets, patents, productive processes, research and development efforts, etc., resting upon the base of an educated and capable workforce. *Id.* at 3-4.

154. *See, e.g.*, BRONWYN H. HALL & FUMIO HAYASHI, RESEARCH AND DEVELOPMENT AS AN INVESTMENT 2, 33 (National Bureau of Economic Research Working Paper No. 2973, 1989).

155. Grundfest Remarks, *supra* note 153, at 4.

156. Landau & Hatsopoulos, *supra* note 152, at 585; *see also* Edwin Mansfield, *Microeconomics of Technological Innovation*, *in* THE POSITIVE SUM STRATEGY 307, 308 (Ralph Landau & Nathan Rosenberg eds., 1986).

157. *See* Grundfest Remarks, *supra* note 153, at 4-5; *Tax Policy Aspects of Mergers and Acquisitions: Hearings Before The House Comm. on Ways & Means*, 101st Cong., 1st Sess. 686 (1989) (remarks of Erich Bloch, Director, National Science Foundation, before the House Ways and Means Committee, Mar. 14, 1989) [hereinafter Bloch Testimony]. Bloch reported that 70% of total U.S. R&D is performed by industry, and that there has been a dramatic decline in the growth of that spending after

continues poorly to prepare its citizens for the demands of a competitive economy.[158]

Aggregate corporate R&D spending was approximately 1.9% of gross national product (GNP) at the end of 1987[159] compared to significantly higher R&D spending levels in both West Germany and Japan.[160] Moreover, U.S. R&D expenditures[161] are also growing at a slower rate than comparable expenditures by our competitors,[162] and indeed may now be on a de-

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1985. He also referred to a National Science Foundation (NSF) study finding that while R&D spending climbed on average 5.8% per year before 1985, in 1987 there was zero real growth over spending levels in 1985 and 1986, after allowing for inflation. *See* discussion *infra* notes 159-63 and accompanying text. *See also* Gene Koretz, *Business Talks a Better R&D Game Than It Plays*, BUS. WK., Aug. 21, 1989, at 20 (estimated real outlays on R&D will increase by under 1% in 1989, compared to 1.3% in 1988 and 3.7% in 1987); Robert Cassidy, *Research Funding for 1989 Won't Even Reach $131 Billion*, RES. & DEV., Jan. 1989, at 47; Ralph E. Winter, *Research Spending in US to Slow in 1989*, WALL ST. J., Dec. 21, 1988, at B3.

158. *See generally* P. Roy Vagelos, *The Sorry State of Scientific Education*, SCI. AM., Oct. 1989, at 128 (arguing that the United States educational system fails to produce students literate in science and mathematics); *see also* MADE IN AMERICA, *supra* note 86, at 21-22.

159. Grundfest Remarks, *supra* note 153, at 5. These figures do not include defense-related military R&D spending, because nondefense R&D is more directly related to national industrial competitiveness issues than is military R&D spending. *Id.* at 5 n.10. Nondefense R&D spending as a percentage of GNP in the U.S. stayed at 1.9% at the end of 1989. *See* National Science Board, Science and Engineering Indicators—1991 (U.S. G.P.O. 1991), at 4, fig. O-2; 109 [hereinafter cited as S&E INDICATORS].

160. West Germany's nonmilitary R&D spending in 1987 was approximately 2.6% of GNP; in Japan, it was 2.7% of GNP. *See* Grundfest Remarks, *supra* note 153, at 5. In 1989, however, nondefense R&D spending had risen to 2.8% of GNP in Germany and 3.0% of GNP in Japan. *See* S&E INDICATORS, *supra* note 159, at 108.

161. The rate of increase in nondefense R&D spending in Japan is striking. Japanese nondefense R&D spending as a percentage of total U.S. nondefense R&D spending has increased from 35% in 1972 to 58% in 1989. *See* S&E INDICATORS, *supra* note 159, at 108. In fact, some reports suggest that total Japanese industrial R&D spending in 1990 may have surpassed total industrial R&D spending in the U.S. *See infra* note 163.

162. *See Missed Opportunities: R&D—A Bigger Push in Japan*, WALL ST. J., Nov. 14, 1988, at R21; *see also* Lindley H. Clark & Alfred L. Malabre, *Slow Rise in Outlays for Research Imperils U.S. Competitive Edge*, WALL ST. J., Nov. 10, 1988, at A1 (rate of corporate spending has slowed markedly, imperiling U.S. competitive stance in world markets).

cline compared to the 1970s.[163]

There is abundant anecdotal evidence suggesting that shortened investment horizons (as evidenced by the decreased growth of corporate investment in research and development) have coincided with the dramatic increase in highly leveraged takeover and/or defensive activity.[164] The evidence from the

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One interesting study of 200 Japanese and U.S. corporations has concluded that while Japan has obtained relatively higher rates of return from applied R&D, the U.S. has obtained relatively higher rates of return from basic R&D. *See* Edwin Mansfield, *Industrial R&D in Japan and the United States: A Comparative Study*, AM. ECON. REV., May 1988, at 223, 225. Because of the higher rate of return to Japanese corporations for applied research, R&D intensity (ratio of R&D spending to sales) in manufacturing firms has increased more rapidly in Japan than in the U.S. *See id.* In contrast to the practices of the 1970s, Japanese corporations now seem to devote "about as large a percentage of their R&D expenditures to relatively risky and long-term projects" as U.S. corporations. *Id.* at 225 & Table 2. Moreover, although increases in the size of U.S. corporations result in less than proportionate increases in R&D expenditures aimed at new processes and products, the opposite is true in Japan, where increases in size tend to result in disproportionately large increases in R&D spending. *See id.* at 227.

163. *See, e.g.*, William J. Broad, *Research Spending is Declining in U.S. as it Rises Abroad*, N.Y. TIMES, Feb. 21, 1992, at A1 (U.S. spending on R&D, after peaking in 1989, has steadily declined). A draft report of the U.S. Competitiveness Policy Council suggests that NSF's use of conversion tables to equalize price levels among countries may disguise the fact that Japan now actually spends more on industrial research than we do. *See* William J. Broad, *Japan Seen Passing U.S. in Research by Industry*, N.Y. TIMES, Feb. 25, 1992, at C1.

There is disagreement over whether a comparison of spending levels is meaningful. The NSF projects Japanese R&D spending at levels considerably lower than those in the U.S., using a purchasing power parity exchange rate calculated by the Organisation for Economic Cooperation and Development that involves a higher yen-to-dollar ratio. *See* S&E INDICATORS, *supra* note 159, at 341 appendix table 4-26.

164. *See, e.g.*, NAS, CORPORATE RESTRUCTURING, *supra* note 115, at 25 (remarks of Stuart E. Eizenstat) (discussing poll of 476 of largest U.S. industrial corporations revealing that R&D budgets of most would not be growing as fast in the next three years as they had in previous three; also, Industrial Research Institute survey of 161 R&D directors reporting that R&D funding as percentage of sales was expected to continue to drop); *Hostile Takeovers and Junk Bond Financing*, *in* KNIGHTS, RAIDERS AND TARGETS, *supra* note 98, at 22 (remarks of Michael D. Dingman, Chairman and CEO of the Henley Group, Inc.) (under short-term performance pressure, managers "cut back on [their] long-term development and other things that have a long-range payback, the investments that ultimately produce the big wins"); NAS, CORPORATE RESTRUCTURING, *supra* note 115, at 104 (remarks of Gregg Jarrell); *id.* at 54-55 (remarks

empirical studies is somewhat more mixed, but is nevertheless troubling in its implications.

In 1989, the National Science Foundation (NSF) published the results of its "Assessment of the Impact of Recent Leveraged Buyouts and Other Restructurings on Industrial Research and Development Expenditures."[165] The NSF Study reported that, following 10 years of increases averaging 5.8% annually in corporate R&D funding, real growth has "all but disappeared." Of the 200 R&D-performing companies surveyed,[166] which accounted for nearly 90% of total corporate R&D spending, 33 firms had recently merged into 16 firms; and an additional 8 firms were involved in leveraged buyouts (LBOs) or other restructurings. These two groups of firms accounted for nearly 20% of total corporate R&D spending in 1987 ($9.2 billion and $600 million, respectively). Whereas all other R&D-performing companies reported a 5.4% increase in R&D spending between 1986 and 1987, these 24 firms had a combined 5.3% *reduction* in R&D spending during the same period. The merged firms together[167] had a 4.7% annual reduction in their own R&D expenditures during a period when R&D spending by all U.S. corporations increased 3.3%. The LBO/restructured firms[168] experienced a total decline in R&D spending during the same period of 12.8%.[169]

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of I. MacAllister Booth, President and CEO of Polaroid Corporation).

Of course, there are also reports to the contrary. *See, e.g.*, KNIGHTS, RAIDERS, AND TARGETS, *supra* note 98, at 25-26 (remarks of Warren Buffett and Michael Jensen); NAS, CORPORATE RESTRUCTURING, *supra* note 115, at 37 (remarks of Michael Tokarz) (reporting that the R&D budget of Duracell Corp. is "dramatically higher under private ownership than it was under public ownership . . . [b]ecause management runs the company and we are the owner and we want long-term value appreciation").

165. 1989 NSF Study, *supra* note 6.

166. Significantly, the survey did not include any companies that sold off substantial R&D performing divisions during the relevant period. Such companies reported "drastic reductions" in R&D spending, but were omitted from the study because the acquired divisions could not be "tracked" after their acquisitions. *Id.* at 681.

167. Of the sixteen mergers, nine firms reported significant reductions in their R&D budgets, three reported little or no change, and four had increases. *Id.* at 686.

168. All eight of the firms involved in LBOs or defensive restructurings experienced significant reductions in R&D spending. *Id.*

169. *Id.* LBO/restructured firms posted a decline in R&D spending even in industries where R&D spending increased significantly during the

These results[170] raise a "warning flag"[171] about the prospects for nonmilitary R&D in the United States. For present purposes, the question is whether the law governing U.S. corporations (and perhaps other financial institutions) has contributed to this increasingly negative aspect of corporate performance.[172]

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relevant period. For example, whereas the chemical industry (including pharmaceuticals) increased R&D spending by 9.8%, R&D spending in the affected chemical companies increased by only 4.5%—less than half the increase in the industry as a whole. The decline in R&D spending, predictably, also affected employment of R&D personnel. During the same period, the twenty-four LBO/restructured firms reported drops in the employment of R&D scientists and engineers of 4.1%, whereas total industrial employment of R&D scientists and engineers increased 1.8%. *See id.* at 687.

170. Other studies concerning the impact of takeovers on R&D spending had demonstrated little or no decrease in R&D *intensity* (the ratio of R&D spending to sales). *See, e.g.*, FRANK R. LICHTENBERG & DONALD SIEGEL, THE EFFECTS OF LEVERAGED BUYOUTS ON PRODUCTIVITY AND RELATED ASPECTS OF FIRM BEHAVIOR 30 (National Bureau of Economic Research Working Paper No. 3022, 1989); Bronwyn H. Hall, *The Effect of Takeover Activity on Corporate Research and Development*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES, 69, 93 (Alan J. Auerbach ed., 1988) [hereinafter Hall, *The Effect of Takeover Activity*] ("[T]he existing data (through 1985) provide very little evidence that acquisitions cause a reduction in R&D spending . . . . At the individual industry level the results were too imprecisely measured to draw solid conclusions.").

The apparent discrepancy between the findings of the 1989 NSF Study, *supra* note 6, with regard to aggregate R&D spending and those of the studies above, with regard to R&D intensity, may result from the decreases in firm size (and sales) that occur after a takeover. Thus, R&D intensity may not decrease despite a considerable decline in overall R&D expenditures. *See* NAS, CORPORATE RESTRUCTURING, *supra* note 115, at 83-84 (comments of Kenneth S. Flamm).

Professor Hall has completed two additional studies that focus on the effects of highly leveraged corporate restructuring (rather than takeovers per se) on R&D spending. Both studies conclude that there is strong evidence of a link between leverage and decreased R&D spending. *See* CORPORATE RESTRUCTURING, *supra* note 98, at 123; HALL, INVESTMENT HORIZONS, *supra* note 6, at 24-25; *infra* notes 173-82 and accompanying text.

171. Bloch Testimony, *supra* note 157, at 688.

172. Although it has been suggested that mergers combining small "innovative" enterprises with larger financially strong corporations may yield intensified R&D efforts, several studies concerning the results of merger activity "provide[] no support for this hypothesis." Ravenscraft & Scherer, *supra* note 20, at 44 ("Lines of business originating from mergers had significantly lower company-financed R&D to sales ratios [shortfalls of 5 to 8.5%] than product lines with similar market shares in the

Through information concerning 2500 publicly-traded manufacturing firms from 1976 to 1987 compiled in a master data file,[173] Professor Bronwyn Hall[174] has advanced our understanding of the legacy of the takeover decade. Her 1990 study of the subset of corporations that underwent restructuring during that period has yielded several interesting conclusions, some of which confirmed the work of other researchers, some of which broke new ground.

Hall initially observed that the leveraged buyouts and other private acquisitions of publicly traded manufacturing firms tended to occur in sectors "where R&D investment and innovation have not been important, at least to the industry as a whole."[175] Thus, even if these corporations drastically reduced

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same industries, but without a merger history.") The Ravenscraft-Scherer studies, cited above, and also DAVID J. RAVENSCRAFT & F.M. SCHERER, MERGERS, SELL-OFFS, AND ECONOMIC EFFICIENCY (1987), as well as others, are sometimes "excluded" from published accounts of the effects of corporate restructurings on R&D spending, because they involve a "conglomerate restructuring wave that is substantially different from current restructuring phenomena." Grundfest Remarks, *supra* note 153, at 12 n.39.

173. *See* CORPORATE RESTRUCTURING, *supra* note 98, at 91-92. The study examined 2,500 U.S. manufacturing firms from Standard and Poor Corp. "Compustat" files. Professor Hall identified several different types of changes in corporate structure and examined every such event: mergers and acquisitions (public and private), leveraged buyouts, and increases in debt position not involving changes of control or ownership. This data base was also utilized in her 1990-1991 INVESTMENT HORIZONS study. See *infra* notes 174-82 and accompanying text.

Approximately 1,200 firms had "exited" from the Compustat files by 1987, the last year of the study. Professor Hall researched the reasons for the exit (type of acquisition, bankruptcy, liquidation, name change, or other reason), the year it occurred, the market price at the time of exit, and the name of any acquiror. She then organized these firms by category: acquisition by public firms (480), acquisition by foreign firms (100), going private transaction (250), bankruptcy/liquidation (130) and others that were "not true exits" (either name changes or delistings). Other firms that increased their leverage substantially (where increase in long-term debt in any one year was greater than 75% of the sum of their debt and equity at the beginning of the year) were singled out and included as firms that had "restructured." *See.* CORPORATE RESTRUCTURING, *supra* note 98, at 92.

174. Hall's work has been prominent in the literature. *See, e.g.*, Hall, *The Effects of Takeover Activity*, *supra* note 170; CORPORATE RESTRUCTURING, *supra* note 98; HALL, INVESTMENT HORIZONS, *supra* note 6.

175. *See* CORPORATE RESTRUCTURING, *supra* note 98, at 121. Hall concludes that "going private" restructurings per se do not pose a signifi-

R&D,[176] the impact on R&D spending generally would have been relatively minor. However, when the focus is broadened from LBOs as such to firms that had moved to a substantially higher leverage position post restructuring, the exhibited decline in R&D intensity (ratio of R&D expenditures to sales) is 0.8% of sales for the period from 1982 to 1987.[177] Moreover, these results involved many firms that, unlike the LBO firms, were doing "significant amounts of R&D" before the restructuring. Finally, Hall discovered "weak" statistical evidence that publicly-traded acquiring firms also appeared to experience "permanent declines in their R&D intensity relative to other firms in their industry."[178]

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cant threat to corporate R&D spending in the United States because "R&D intensive firms and high-technology industries are not good candidates for these acquisitions." *Id.* at 102. Such firms do not have the "cash flow properties" needed to service the debt incurred by the transaction. *Id.* at 96. Moreover, the assets of R&D intensive firms tend to be "not very redeployable (and . . . often difficult to transfer without substantial investments by the receiving firm."). *Id.* Thus the "cash flow and asset specificity considerations argue strongly that leveraged buyouts will not take place in firms and industries in which research and development is important." *Id. Accord, e.g.*, Abbie J. Smith, *Corporate Ownership Structure and Performance: The Case of Management Buyouts*, 27 J. FIN. ECON. 143, 154-155 (1990). *See also* HALL, INVESTMENT HORIZONS, *supra* note 6, at 14 (firms with stable short project development horizon or low technology—i.e., low variance in cash flow and investment strategies—are "far more likely" to undergo LBOs than others).

176. Not all studies of LBOs have reported decreases in R&D spending. A study by Lichtenberg & Siegel, concluded that R&D intensity for 43 LBO firms between 1978 and 1986 "tended to increase" over this period. LICHTENBERG & SIEGEL, *supra* note 170, at 30. During the same period, the R&D intensity of "all R&D performers [also] increas[ed] significantly," however, and the *"relative* R&D intensity of LBO firms . . . therefore increased less than the absolute R&D intensity." *Id.* The authors concluded that their data "cast doubt on the hypothesis that LBOs are associated with reductions in the propensity to perform R&D." *Id.* However, Hall's study on investment horizons strongly suggests it is the leverage, rather than the buyout per se, in the LBO that is associated with reductions in R&D spending. *See supra* note 6 and accompanying text.

177. *See* CORPORATE RESTRUCTURING, *supra* note 98, at 122.

178. *See id.* Since R&D intensity declined .05% in the "more leveraged of the acquisitions," Hall concluded this tended to "lend[] credence to arguments that cash flow affects R&D spending." *Id. But see* LICHTENBERG & SIEGEL, *supra* note 170, at 30. While acknowledging the imprecision of these statistical results and the variability of the experiences of firms in the sample, Hall concluded that "the link between leverage and reduced R&D spending has been established." *Id.* at 123.

Unlike other empirical studies in the area,[179] Professor Hall's study focused on leverage itself, rather than on changes of control per se, and suggested that the "effect of changes in debt on R&D spending [is] strongly negative."[180] Her follow-up study, *Corporate Restructuring and Investment Horizons*,[181] reinforces these earlier findings.[182] These results,

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Moreover, her follow-up 1990-1991 study concerning investment horizons provided even stronger evidence of the linkage between leverage and decreased R&D spending. *See infra* notes 179-82 and accompanying text.

179. Hall believes her study to be "the only study, outside of a few case studies, to look specifically at large financial restructurings which are not accompanied by a change of control." HALL, INVESTMENT HORIZONS, *supra* note 6, at 9. As this article goes to publication, I am aware of no other such study.

180. CORPORATE RESTRUCTURING, *supra* note 98, at 120.

181. HALL, INVESTMENT HORIZONS, *supra* note 6. Professor Hall explained that her data could be interpreted to imply "reductions in the rate of investment of the order of 50 percent" in the year of a restructuring and the two years following it, where the financial restructuring increased long-term debt by the size of the capital stock. *Id.* at 11. The greatest pressure for reduced investment (and the greatest likelihood of takeover) occurred in long horizon industries where raiders (and the capital market) presumably rejected the previous investment strategies of management. Whether this course of action was warranted depends in part on the real level of market efficiency. As Professor Hall observes, "unless one is a doctrinaire believer in efficient markets, this evidence is not enough to persuade one that all the investments forgone were unprofitable." *Id.* at 21.

182. Professor Hall divided the industrial corporations into four sectors, each of which utilizes different technologies: (1) high technology (non-cosmetic pharmaceuticals, computing equipment, electrical machinery, electronics, aircraft and aerospace, instruments), (2) low technology (food, textiles, lumber, furniture, paper, miscellaneous manufacturing (toys, leather, musical instruments, etc.)), (3) stable long horizon (non-pharmaceutical chemicals, petroleum, primary metals, engines and construction equipment, non-electrical machinery, automobiles (excluding parts)), and (4) stable short horizon (rubber and plastics, stone, clay and glass, fabricated metals, cosmetics, motor vehicle parts.) HALL, INVESTMENT HORIZONS, *supra* note 6, at 13-14. She found that LBO-induced increases in leveraging are more likely to occur in firms with stable short horizons and low technology, which are consistent with LBOs requiring a "low variance in cash flow and investment strategies in order to be profitable." *Id.* at 14.

However, stable long horizon firms are more than twice as likely as firms in the other three sectors to undertake substantial leverage increases; moreover, this occurs in firms "almost as R&D intensive" as other firms in the sector. Thus, Hall concludes, pressure to restructure is especially concentrated in sectors in which, because of size or complexity,

while consistent with the financial realities of high degrees of leveraging,[183] i.e., the demands upon cash flow, raise concerns for corporate innovation in U.S. corporations.

Innovation is a time-consuming and costly process. Rarely does innovation burst upon the scene. Rather, it develops gradually, and requires the investment of substantial resources for an extended period. For this reason, a successful innovative firm typically must plan for a high degree of fixed costs, and must coordinate the development of interrelated activities involving basic R&D, production processes and, eventually, marketing. Successful innovation, then, requires managers to sustain corporate financial commitment for an extended period before returns begin to accrue.[184] The much vaunted investment "discipline" that high leverage exerts upon managers unable to retain earnings, coupled with possible allocational inefficiencies and informational asymmetries in capital markets, put at risk the capacity for sufficient financial commitment to innovation.

4. Role of the Cost of Capital

a. Comparisons with Germany and Japan

There is, as noted above, general agreement that levels of investment growth (and in particular R&D growth) have been diminishing.[185] There is far less agreement about the causes

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investment is necessarily long-term and technology has long horizons. *Id.* at 15. Stable long horizon firms that experience increases in leverage also experience "larger declines in investment than firms in the high or low technology sectors," but only proportional declines in R&D spending. *Id.* at 16. Nevertheless, as Professor Hall explains, these decreases in R&D spending following leverage increases "loom very large" given that "the outstanding characteristic of R&D spending patterns . . . is their sluggishness in the face of any kind of change." *Id.* at 16, sources cited at 5 n.6.

183. *See supra* notes 170-82 and accompanying text.

184. *See, e.g.*, FOLEY & LAZONICK, *supra* note 96, at 8:

> Innovation is an ongoing process . . . [that] requires . . . *financial commitment* . . . . [i.e.,] the ability . . . to maintain *sustained* access to financial resources so that [the firm] can pursue innovative strategies to a successful conclusion [allowing the firm] to invest in the coordination of complex specialized divisions of labor over the long time period required before returns can be generated.

Id.

185. *See supra* notes 151-69 and accompanying text.

of that decline. The cost of capital[186] in the United States, relative to competitor nations abroad, is frequently blamed for this decreased growth in R&D spending. Indeed, those who reject managerial/shareholder myopia as a cause of the relative decline in R&D growth blame it entirely on the high cost of capital,[187] an undeniably important contributing factor.[188]

The comparative figures concerning the cost of R&D, for example, are indeed, as then Commissioner Grundfest observed, "truly frightening."[189] A recent study by the Federal Reserve Bank of New York reported that the annual effective cost for a benchmark R&D project in the U.S. was 20.3%, compared to 14.8% in Germany and 8.7% in Japan.[190] Thus, R&D

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186. One definition of the cost of capital is "the minimum before-tax real rate of return that an investment project must generate in order to pay its financing costs after tax liabilities." Robert N. McCauley & Steven A. Zimmer, *Explaining International Differences in the Cost of Capital*, 14 FED. RES. BD. N.Y. QUAR. REV., Summer, 1989 at 7, 8.

187. *See, e.g.*, Grundfest Remarks, *supra* note 153, at 6-8; Gilson & Kraakman, *Outside Directors*, *supra* note 10, at 882 n.68.

188. Reportedly, Japanese corporations have generally enjoyed lower debt and equity costs than U.S. corporations. German corporations have enjoyed lower debt costs. McCauley & Zimmer, *supra* note 186, at 9-13. Thus, the cost of funds (the amount required for payments to a firm's debt and equity holders)—an economic measure frequently equated with the cost of capital—is lower in both Germany and Japan than in the United States. *Id.* at 8, 13.

Calculating the cost of funds is an intermediate step in calculating the cost of capital, i.e., those investment costs that must cover both the after-tax cost of funds and tax obligations. *Id.* at 15. The low cost of funds in Japan and Germany is advantageous in the funding of long-term projects. McCauley and Zimmer observe required rates of return in these two countries for a 10-year R&D project of 8.7% and 14.8%, respectively, as compared to a 20.3% required rate of return for such a project in the U.S. *Id.* at 16. These rates illustrate "how a relatively high cost of funds erects a high hurdle for investments with delayed payoff." *Id.* at 15.

189. Grundfest Remarks, *supra* note 153, at 6. *See* McCauley & Zimmer, *supra* note 186, at 15, table 2; *supra* notes 159-63 and accompanying text; *see also* Landau & Hatsopoulos, *supra* note 152, at 604 (basic differential in cost of capital would permit Japanese companies to invest in longer-term R&D projects or to invest far more than comparable U.S. corporations).

190. These figures, which represent the "minimum before-tax real rate of return that an investment project must generate in order to pay its financing costs after tax liabilities," were for 1988. McCauley & Zimmer, *supra* note 186, at 8, 16, table 2; *see also* George N. Hatsopoulos & Stephen H. Brooks, *The Gap in the Cost of Capital: Causes, Effects, and*

may be more than twice as expensive in the United States as in Japan. Moreover, because of our relatively higher capital costs, American investors require faster payoff periods than do German and Japanese investors, and hesitate to undertake the risky R&D projects being conducted in Germany and Japan.[191]

It is often suggested that our capital costs are higher than our competitors because our savings rate is lower[192] and our price and interest rate volatility is greater.[193] The personal savings rate in Japan averages approximately three times that of the United States (17-18% of disposable income as compared to approximately 5-8% in United States).[194] The result of this abundance of capital in Japan and its relative scarcity in the

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Remedies, *in* TECHNOLOGY AND ECONOMIC POLICY 221 (Ralph Landau and Dale W. Jorgenson eds., 1986); Albert Ando & Alan J. Auerbach, *The Cost of Capital in the United States and Japan*, 2 J. JAPANESE AND INT. ECON. 134 (1988); Albert Ando & Alan J. Auerbach, *The Corporate Cost of Capital in Japan and the United States: A Comparison*, *in* GOVERNMENT POLICY TOWARDS INDUSTRY IN THE UNITED STATES AND JAPAN 21 (John Shoven ed., 1988) [hereinafter Ando & Auerbach, *The Corporate Cost of Capital*]; Elizabeth Corcoran & Paul Wallich, *The Analytical Economist: The Cost of Capital*, SCI. AM. (Oct. 1989), at 79, 79. *But see* Gene Koretz, *Soon, Japan Will Wave Goodbye to Cheap Capital*, BUS. WK., Sept. 30, 1991, at 16 (because of 40% overall decline in share prices on Tokyo market, holders of $220 billion in convertible or warrant bonds will seek to cash out in 1992-94 rather than convert, creating a need for enormous cash reserves for Japanese corporations, driving cost of capital up significantly).

191. *See, e.g.*, B. Douglas Bernheim & John B. Shoven, *Taxation and the Cost of Capital: An International Comparison*, *in* THE CONSUMPTION TAX: A BETTER ALTERNATIVE? 61, 77 (Charles E. Walker & Mark A. Bloomfield eds., 1987) (noting that as a result of changes in the United States' tax code between 1980 and 1985, "the United States replaced West Germany as the country with the highest cost of capital"). Accordingly, a relatively lengthy research project might be feasible in Japan and impossible in the United States because American investors demand faster payoff periods. *See* Grundfest Remarks, *supra* note 153, at 7 (average break-even period for new investment in U.S. is 5.7 years as compared to 10.3 years in Japan).

192. *See, e.g.*, McCauley & Zimmer, *supra* note 186, at 17, chart 8.

193. *See* Grundfest Remarks, *supra* note 153, at 7.

194. *See* McCauley & Zimmer, *supra* note 186, at 17, chart 8. In fact, there has been such an excess supply of personal savings in Japan that it has generated controversy about the "domestic capability [of the business and government sectors] to absorb the excess savings of the household sector." Masahiko Aoki, *The Macroeconomic Background for High-Tech Industrialization in Japan*, *in* THE POSITIVE SUM STRATEGY 569, 577 (Ralph Landau & Nathan Rosenberg eds., 1986).

U.S. is that Japan exports in excess of $40 billion of capital annually, whereas the United States annually imports approximately $100 billion of capital to finance investments and government deficits.

Although Japan's household savings rate is higher, German families also significantly outsave U.S. families.[195] This may be due entirely to different habits of thrift. That explanation ignores, however, other factors that significantly influence the savings rate, including the timing of wage and salary payments in Japan (approximately 1/6 yearly wage paid in year-end bonuses), and the relative scarcity of consumer credit in both countries compared with the U.S.[196] In addition to the personal savings rate, the relative macroeconomic stability of Japan and Germany greatly contributes to lowering the cost of capital in those countries.[197] Both Japan and Germany enjoy lower price volatility than does the U.S.[198] That low price volatility enables Japanese and German investors to accept relatively lower rates of return on debt.[199] Moreover, returns on equity are significantly higher in the United States than in Japan and other competitor nations.[200] The demand for relatively higher returns on equity, coupled with a higher interest rate than is available in Japan and Germany, result in significantly higher capital costs for U.S. corporations than for their Japanese and German competitors.[201]

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195. *See* McCauley & Zimmer, *supra* note 186, at 17, chart 8 (German households save approximately twice as much as U.S. households).

196. *See, e.g., id.* at 18.

197. *But see* Ferdinand Protzman, *German Inflation Rate Shows A Sharp Increase*, N.Y. TIMES, March 11, 1992, at D2 (the annual rate of inflation rose in February to 4.3%, reducing the likelihood that interest rates would be lowered to stimulate the German economy); James Sterngold, *Japan's Statistics Point to a Slump, Ending Long Boom*, N.Y. TIMES, March 9, 1992, at A1, D2 (depression in stock market has increased cost of capital; decreased spending leading to cutbacks in production.)

198. McCauley & Zimmer, *supra* note 186, at 20, chart 11.

199. *Id.* at 19 & chart 12.

200. *See* NAS, CORPORATE RESTRUCTURING, *supra* note 115, at 29 (remarks of Roger Altman) [hereinfter Altman Remarks]; McCauley & Zimmer, *supra* note 186, at 19.

201. *But see* Ando & Auerbach, *The Corporate Cost of Capital*, *supra* note 190, at 31-37, 46-47 (there "do not seem to be any grounds to conclude that the cost of capital in Japan [between 1971-81] was significantly lower than that in the United States," although there is "some evi-

b. Does Leveraging Pose Greater Risks for U.S. Firms?

The dominant sources of corporate funding and the nature of private financial institutions (particularly banks) within the three nations also influence the cost of capital. Equity markets provide a relatively small percentage of externally generated capital in all three, since the nonfinancial corporations of Germany,[202] Japan and the U.S. raise only a small fraction of such funds through (relatively costly) equity issues.[203] German,[204] Japanese and U.S. corporations raise a considerable percentage of their funds through debt. However, notwithstanding the recent rise in U.S. corporate indebtedness,[205] Japanese[206] firms have substantially higher debt-to-equity ratios than do comparable U.S. firms.[207] Japanese corporations

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dence of lower before-tax rates of return in Japan, though . . . this result is by no means definitive").

202. German corporations rely very little on equity markets for externally generated funds. Indeed, only 402 German corporations have shares listed on the eight German stock exchanges. *See* 2 DEPARTMENT OF TRADE AND INDUSTRY, BARRIERS TO TAKEOVERS IN THE EUROPEAN COMMUNITY 26 (1989) [hereinafter Coopers & Lybrand Report]. Bank borrowing accounts for 20% of total enterprise funds, the largest source of externally generated funding for German corporations. *See* John Cable, *Capital Market Information and Industrial Performance: The Role of West German Banks*, 95 ECON. J. 118, 119 (1985); *Liquidity Versus Control*, *supra* note 83, at 1302, nn.96-98.

203. *See* J. Hodder, *Corporate Capital Structure in the United States and Japan: Financial Intermediation and Implications of Financial Deregulation*, in GOVERNMENT POLICY TOWARDS INDUSTRY IN THE UNITED STATES AND JAPAN 241, 247 & figs. 9.2-9.3 (J. Shoven ed. 1988) (3.5% in Japan; 2.6% in U.S.).

204. German corporations raise most of their externally generated funds through long-term loans from their primary banks. *See supra* note 202; *see also* Coopers & Lybrand Report, *supra* note 202, at 16.

205. *See supra* notes 131-40 and accompanying text.

206. Long-term corporate bonds account for only a small percentage of externally generated funds of Japanese corporations. *See* Hodder, *supra* note 203, at 248, table 9.2 (2% average for 1973-1984). In 1984, only 4% of the capital structure for nonfinancial companies listed on the Tokyo Stock Exchange consisted of bonds. *Id.* at 247. By contrast, bonds account for an average of 41% of externally generated funds of U.S. corporations. Between 1974-1983, on average, U.S. corporations raised slightly more of their externally generated funds from market debt instruments than from financial institutions (13.7% and 13.4%, respectively), whereas Japanese corporations raised roughly 75% of externally generated financing (37% overall) from private financial intermediaries. *Id.*

207. *See id.* at 245.

generate only slightly more than 50% of funds internally (51.7% average for 1973-1984), compared to a 70% average for comparable U.S. corporations.[208]

Significantly, the role of financial intermediaries differs in the three countries. German corporations are extremely dependent upon their banks (which enjoy "universal" banking powers) for external finance,[209] and Japanese industrial firms also obtain the majority of externally generated financings from private financial intermediaries.[210] By contrast, a significant percentage of funds of U.S. corporations is generated through corporate bonds,[211] with only a slightly larger percentage through loans from private financial institutions.[212]

In Japan, private financial institutions (banks and insurance companies)[213] hold nearly 40% of shares on the Tokyo Stock Exchange[214] which amount to nearly half of the externally-

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208. *See id.*

209. *See Liquidity Versus Control*, *supra* note 83, at 1302-03 & n.96; Cable, *supra* note 202, at 119-21. Bank borrowing is the largest source of externally generated funds for German nonfinancial corporations; moreover, banks are the dominant securities brokerages controlling most new securities issues. *See id.* at 119.

210. *See* Hodder, *supra* note 203, at 248 & fig. 9.2 (average of 37% for 1973-1984).

211. *See supra* note 206; Hodder, *supra* note 203, at 249 & fig. 9.3 (9.4% average for 1973-1984).

212. Hodder, *supra* note 203, at 249 & fig. 9.3 (13.4% average from private financial institutions; compared to 9.4% average from corporate bonds in 1973-1984).

213. Under section 11 of Japan's Law No. 54 of 1947, insurance companies could then own up to 10% of the equity of domestic corporations. *See* Coffee, *Liquidity Versus Control*, *supra* note 83, at 1295 n.62.

214. *See* Hodder, *supra* note 203, at 251-52 & fig. 9.4 (38% of listed shares and 35.6% of market value in 1984). Only a small percentage of listed shares is held by individual investors, with the bulk held through cross-ownership by members of the various keiretsu. *See* ARON VINER, INSIDE JAPANESE FINANCIAL MARKETS 56 (1988) (estimating 65% cross-ownership); Stephen Barber, *A Close Circle of Friends*, INSTITUTIONAL INVESTOR, Feb. 1991, at 35 (reviewing ROBERT Z. LIELINSKI & NIGEL HOLLOWAY, UNEQUAL EQUITIES: POWER AND RISK IN JAPAN'S STOCK MARKET (1991) and noting that the authors estimate 70% cross-ownership).

Although U.S. banks are prohibited from owning corporate equity, bank holding companies are authorized to own up to 5% of the voting shares of a non-banking corporation and up to 25% of the non-voting stock of such a corporation. *See* Bank Holding Company Act of 1956, §4(c)(6)-(7), 12 U.S.C. § 1843(c)(6)-(7) (1992); Pauline B. Heller, FEDERAL BANK HOLDING COMPANY LAW § 4.03(2)(a), at 4-60.8 to 4-60.10 (1989).

held listed shares.[215] German banks own a far smaller percentage outright, but exercise comparable control (approximately 34% voting power in the top one hundred corporations and over 50% of the voting power in the ten largest corporations) because of their importance in the securities industry,[216] and because they vote the shares deposited in banks by the shareholders.[217] U.S. banks are prohibited both from outright ownership of equity securities[218] (although bank holding companies are permitted to own up to 5% of the voting shares of a nonbanking corporation)[219] and direct participation in the

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See infra notes 218-20, 380-84 and accompanying text. Given the close connections fostered by substantial share ownership within the creditor-debtor relationship, and the relational continuity of the keiretsu structure, Japanese banks exercise more influence in corporate affairs than do American banks. *See* John S. Reed & Glen R. Moreno, *The Role of Large Banks in Financing Innovation*, *in* THE POSITIVE SUM STRATEGY 453, 456 (Ralph Landau & Nathan Rosenberg eds., 1986); *infra* notes 224-29 and accompanying text. German banks, which, unlike their U.S. and Japanese counterparts, have universal banking powers, also function as house banks with considerable influence inside and outside the board room. *See* Reed & Moreno, *supra*, at 456-457. *See also* Sun Bae Kim, *Should Banks Hold Shares in Nonfinancial Firms?*, AM. BANKER, April 24, 1991, at 4 (noting European Community plans to adopt "universal" banking; German, French, and Italian banks already have that power).

215. Corporations hold another 25.9% of each others' listed shares, substantially as parent-subsidiary or interfirm holdings; if these are subtracted from aggregate holdings, financial institutions own approximately half of the remaining externally-held listed shares. *See* Hodder, *supra* note 203, at 253 & fig. 9.4.

216. Unlike Japanese and U.S. banks, German banks are not restricted to any maximum percentage of equity ownership. *See* Cable, *supra* note 202, at 120-21; Coffee, *Liquidity Versus Control*, *supra* note 83, at 1303-04 n.99.

217. *See* Coopers & Lybrand Report, *supra* note 202, at 13-14; Cable, *supra* note 202, at 120.

218. Despite this prohibition on bank equity participation, institutional investors in the U.S. (excluding investment banks, bank holding companies and some trustees) are reported to own nearly 45% of the equity in the United States. *See* Carolyn Kay Brancato, *The Pivotal Role of Institutional Investors in Capital Markets*, *in* INSTITUTIONAL INVESTING: THE CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY 3, 17-19 (Arnold W. Sametz ed., 1991).

219. National banks enjoy only certain limited and specified powers under the National Bank Act of Feb. 25, 1863, §11, 12 U.S.C. §24 (seventh) (1988). Equity participation is not among them. State chartered banks within the Federal Reserve are subject to similar restrictions. *See* Banking Act of 1933 (Glass-Steagall), §5(c), 12 U.S.C. §335 (1988).

It has been suggested that such restrictions on financial institutions

securities industry.[220] Japanese banks, although permitted to own equity shares in their own right,[221] are subjected to statutory restrictions by the Japanese equivalent of the Glass-Steagall Act,[222] which separates commercial banking from investment banking activities.[223]

The major Japanese and German banks, to a far greater extent than their U.S. counterparts, function as financial intermediaries that can lower the costs incurred in the event of firm failure, i.e., bankruptcy.[224] They are, therefore, effectively able to lower the cost of capital itself.[225]

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have disabled banks and other private financial institutions from effectively participating in monitoring and control of U.S. corporations. *See* Roe, *supra* note 117. *But see* Coffee, *Liquidity Versus Control*, *supra* note 83, at 1295-96 & n.63 (limitations are overstated since bank holding companies are permitted to own up to 5% of the voting shares of a nonbanking company under Bank Holding Company Act of 1956, § 4(c)(6)-(7), 12 U.S.C. § 1843(c)(6)-(7) (1988)). For further discussion of the monitoring role of financial intermediaries, see *infra* notes 374-94 and accompanying text.

220. *See supra* notes 218-19 and accompanying text; Banking Act of 1933, §§ 16, 20-21 & 23; 12 U.S.C. §§ 24, 78, 377-78 (1988). Even bank trust departments are closely regulated with regard to equity holdings. *See, e.g.*, 12 C.F.R. § 9.18(b)(9)(ii) (1990) (restricting investment in the stock of any single corporation to 10% of trust funds). This restriction followed the Patman Report, which cautioned against the growing influence of bank trust departments. *See* Commercial Banks and Their Trust Activities: Emerging Influence on the American Economy 1-4, 1 STAFF OF THE HOUSE SUBCOMM. ON DOMESTIC FINANCE, COMM. ON BANKING AND CURRENCY, 90th Cong., 2d Sess., (1968).

221. Japanese lenders are frequently substantial equity holders in debtor corporations. *See* Stephen D. Prowse, *Institutional Investment Patterns and Corporate Financial Behavior in the United States and Japan*, 27 J. FIN. ECON. 43, 46-47 (1990) (on average, the largest corporate debtholder owned 6.2% of equity; five largest debtholders owned 18.2% of equity; largest debtholder was largest equityholder in 57 out of 133 cases). *See supra* notes 213-14 and accompanying text.

222. *See supra* note 219, *infra* note 223 and accompanying text.

223. *See supra* notes 218-20 and accompanying text; *see* Banking Act of 1933, §§ 16, 20, 21, 23; 12 U.S.C. §§ 24, 78, 377-78 (1988). Section 65 of Japan's Securities Exchange Act of 1948, Law No. 25 of 1948, prohibits Japanese banks from engaging in investment banking. In addition, since 1987, Japanese banks may not own more than 5% of the equity of any domestic corporation. *See* Section 11(a), Law No. 54 of 1947.

224. *But see* Sterngold, *supra* note 197, at D1 ("[B]ankruptcies [of Japanese corporations] are soaring as big declines in stock and property prices hurt speculators. Banks are reluctant to lend because of a mounting toll of bad loans.").

225. *See* Hodder, *supra* note 203, at 253; Takeo Hoshi et al., *Corpo-*

Financial intermediaries can lower the risk of failure for highly leveraged firms in two ways: first, by monitoring and restraining (if necessary) management risk-taking, thereby reducing the risk of bankruptcy overall; second, by intervening, if necessary, to facilitate firm reorganization without losing the confidence of employees, customers and suppliers.[226] In Japan, for example, financial intermediaries have traditionally performed both of these functions.

When a major Japanese firm suffers financial difficulty, its main bank decides whether or not to launch a rescue effort. If the bank does intervene, the transition back to health can be accomplished relatively smoothly and without major disruption[227] because Japanese main banks have traditionally had stable,[228] long-term relationships[229] with their major indus-

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rate Structure, Liquidity, and Investment: Evidence from Japanese Industrial Groups, 106 Q.J. ECON. 33 (1991) (institutional arrangements in Japan offer Japanese firms an important competitive advantage); David P. Hale, *Learning from Germany and Japan*, WALL ST. J., Feb. 4, 1991, at A10 (advocating lowering of barriers between banking and commerce to enable banks to replace takeover market as monitor for management); Paul Sheard, *The Main Bank System and Corporate Monitoring and Control in Japan*, 11 J. ECON. BEHAV. & ORG. 399 (1989). *But see* Robert E. Litan, *The Dangers of Letting Banks Own Everything*, WALL ST. J., Feb. 5, 1991, at A22 (cautioning against universal banking as increasing risks to federal deposit insurance and creating unequal advantages for insured banks over other, non-bank companies).

226. *See* Hodder, *supra* note 203, at 254.

227. *See id.* One prominent Japanese example involves Sumitomo Bank, which in 1974 rescued a floundering Toyo Kogyo (Mazda) by sending bank executives to take over Toyo Kogyo's management, guaranteeing the loans of other creditors and, through Sumitomo Trust (another member of Sumitomo Group), making commitments for further loans if necessary in the future. Throughout the extended crisis, none of Toyo Kogyo's seventy-one other lenders ever called in a loan or refused to roll over existing short-term credit agreements. Moreover, layoffs were unnecessary, although some workers moved from production to sales for a period of time. *See id. See also* Richard Pascale & Thomas P. Rohlen, *The Mazda Turnaround*, 9 J. JAP. STUD. 219, 228-30 (1983). For a comparable German account, see, e.g., Robert Ingersoll & Rose Brady, *The Banker Behind the Shakeup at Daimler-Benz*, BUS. WK., July 27, 1987, at 36 (Deutsche Bank, 28% shareholder, replacing senior executives at struggling Daimler-Benz). Those experiences are in stark contrast to the events surrounding Chrysler's financial woes in the late 1970s and early 1980s, when an Act of Congress and a loan guarantee backed by the U.S. Treasury were required to rescue the floundering corporation. *See* Hodder, *supra* note 203, at 254-55; *see generally* ROBERT B. REICH & JOHN D. DONAHUE, NEW DEALS: THE CHRYSLER REVIVAL AND THE AMERICAN SYSTEM (1985).

228. *But see* Coffee, *Liquidity Versus Control*, *supra* note 83, at 1298-

trial borrowers and own substantial blocks of their shares. Because of the intensity of these relationships and the dependence of heavily-leveraged corporations upon their main banks, main banks have unique access to confidential information about the corporation's operations and plans.[230] Their continued support in times of difficulty is frequently conditioned upon their exercise of considerable influence upon corporate spending, and other short- and long-term policy decisions.[231] Nevertheless, their control depends upon the corporation's need for capital, and has been described as "weak" when capital is not scarce.[232]

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99 & nn.79-81 (noting that the stability of these relationships is changing). *See supra* note 224, *infra* note 232, and accompanying text.

229. Although there is increasing competition among the major lenders, their small number (approximately ten top banks control lending to major industrial corporations), common interests and shared knowledge tend to facilitate policy coordination and greatly reduce lending risks. *Cf.* Douglas W. Diamond, *Financial Intermediation and Delegated Monitoring*, 51 REV. ECON. STUDS. 393 (1984) (financial intermediary, such as bank, can be delegated to monitor financial information concerning debtor-firms, reducing agency costs overall by eliminating duplicative monitoring by other creditors of debtor-firm, and solving free-rider problem where no creditors monitor). Professor Diamond's model "focuses on a financial intermediary who raises funds from many lenders (depositors), promises them a given pattern of returns, lends to entrepreneurs, and spends resources monitoring and enforcing loan contracts with entrepreneurs which are less costly than those available without monitoring." *Id.* at 394.

230. Because small lenders tend to follow the lead of the Japanese main banks with regard to a corporation's creditworthiness, and the majority of corporate loans are short-term and must be rolled over, these main banks have enormous power. *See* Hodder, *supra* note 203, at 257.

Professor Stiglitz suggests that the two institutions with the greatest incentives to effectively monitor management are banks and unions. Joseph E. Stiglitz, *Credit Markets and the Control of Capital*, 17 J. MONEY CREDIT & BANKING 133, 148 (1985). It is interesting to note that, because of co-determination and universal banking, German corporations have installed both of these groups as monitors of corporate performance—a system frequently praised for its efficiency. *But see* Joseph F. Esser, *Bank Power in West Germany Revised*, WEST EUR. POL., Summer 1990, at 17, 27 (suggesting that management is "usurping the controlling function of the supervisory boards").

231. Indeed, this influence may amount to veto power and involve the replacement of senior managers with bank executives. *See* Hodder, *supra* note 203, at xx; *see also supra* note 227 and accompanying text.

232. *See, e.g.*, JAMES C. ABEGGLEN & GEORGE STALK, JR., KAISHA, THE JAPANESE CORPORATION 189 (1985) ("Banks must now solicit attrac-

German banks arguably exercise still greater control over their client corporations. Indeed, because of their remarkable voting power,[233] they hold nearly ten percent of the total seats on the supervisory boards[234] of Germany's one hundred largest firms.[235]

Monitoring by banks in Japan and Germany seems to have decreased ongoing agency costs for other lenders and investors,[236] while facilitating efficient "liquidation or rescue decision[making]" when necessary, with minimal operational disruption and often without recourse to costly bankruptcy proceedings.[237] Thus, for example, Japan's main bank system, by

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tive borrowers, and find themselves providing funds to the weaker companies, in which their power remain considerable. The most successful of Japan's companies . . . are hardly under bank control.").

233. *See supra* notes 216-17 and accompanying text.

234. German corporations law provides for a two-tier structure: a supervisory board on which managers do not sit, and a managing board. For an early description that retains vitality, see Detlev F. Vagts, *Reforming the "Modern" Corporation: Perspectives from the German*, 80 HARV. L. REV. 23, 50 (1966). For discussions of the role of labor representation on the supervisory board, see ALFRED L. THIMM, THE FALSE PROMISE OF CODETERMINATION (1980); Klaus J. Hopt, *European Community, New Ways in Corporate Governance: European Experiments with Labor Representation on Corporate Boards*, 82 MICH. L. REV. 1338 (1984).

235. *See* Cable, *supra* note 202, at 119. *But see* Esser, *supra* note 230, at 26 (representation on the supervisory boards of the hundred largest German firms has dropped to 7%). *See also New Dreams at Deutsche Bank*, ECONOMIST, June 22, 1991, at 79 (Deutsche Bank, Germany's leading universal bank, has begun relinquishing the chairmanship of supervisory boards of German corporations). Nevertheless, bank influence remains substantial. *See, e.g.*, Hermann H. Kallfass, *The American Corporation and the Institutional Investor: Are There Lessons From Abroad? The German Experience*, 3 COLUM. BUS. L. REV. 775, 783 (1988).

236. The nature of monitoring provided by Japanese and German banks is not uncontroversial. In Japan, for example, although the main bank within a keiretsu has remarkable capability to consult with management and advance the interests of all shareholders, it has been suggested that it may choose rather to ally itself primarily with management, intervening only in times of financial distress or sustained unprofitability. *See Liquidity Versus Control*, *supra* note 83, at 1299. Reform of the German system is surveryed in Friedrich K. Kubler, *An International Perspective: Institutional Owners and Corporate Managers: A German Dilemma*, 57 BROOK. L. REV. 97 (1991). For the declining influence of Japanese and German banks, see *supra* notes 232, 235 & *infra* notes 237, 243. For a discussion of proposals to enhance the monitoring role of U.S. financial institutions, see *infra* notes 374-94 and accompanying text.

237. *See* Hodder, *supra* note 203, at 258.

guaranteeing the supply of credit to industrial corporations, has decreased the need to issue equity and permitted Japanese firms to finance growth with a high degree of debt plus a minimal risk of bankruptcy.[238]

The governmental response to corporate distress in Japan and Germany also seems to reinforce the potential for higher degrees of leverage with relatively low costs from financial failure. In Japan, the government manipulates antitrust exemptions that result in higher prices through cuts in capacity and extends official loans to spread the costs of shrinking industries to taxpayers.[239] Germany achieves similar results primarily through outright subsidies to declining industries.[240] Although the U.S. has intervened to assist a floundering Chrysler[241] and occasionally has subsidized industries "under pressure,"[242] these instances are truly exceptional. Given the improbability of official "bailouts" relieving creditors and investors of U.S. corporations of the full risks of financial distress (outside of the savings and loan industry), the costs of failure will continue to be compensated ex ante through higher capital costs.

Although there are signs of change in the relationships of Japanese and German corporations to their primary banks,[243]

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238. *See* Hodder, *supra* note 203, at 259.

239. *See* McCauley & Zimmer, *supra* note 186, at 24; *see also* Merton J. Peck et al., *Picking Losers: Public Policy Toward Declining Industries in Japan*, *in* GOVERNMENT POLICY TOWARDS INDUSTRY IN THE UNITED STATES AND JAPAN 195-239 (J. Shoven ed., 1988).

240. *See* McCauley & Zimmer, *supra* note 186, at 24.

241. *See supra* notes 227 and accompanying text. The U.S. government also assisted a failing Lockheed, but these two examples pretty much exhaust the list of substantial overt governmental intervention.

242. McCauley & Zimmer, *supra* note 186, at 24.

243. There are indications that the increasing availability of credit (both from abroad and from other domestic lenders), coupled with a buildup of internal financial resources, is weakening the hold of Japanese and German banks overall. For Japan, see, e.g., W. CARL KESTER, JAPANESE TAKEOVERS 187-217 (1991); J. Mark Ramseyer, *Legal Rules in Repeated Deals: Banking in the Shadow of Defection in Japan*, 20 J. LEGAL STUD. 91, 98 n.18, 107-08 (1991); Takeo Hoshi et al., *Bank Monitoring and Investment: Evidence from the Changing Structure of Japanese Corporate Banking Relationships*, *in* ASYMMETRIC INFORMATION, CORPORATE FINANCE, AND INVESTMENT 105-26 (R. Hubbard ed., 1990); Abegglen & Stalk, *supra* note 232, at 166, 189; McCauley & Zimmer, *supra* note 186, at 25. For Germany, see, e.g., Kubler, *supra* note 236, at 100 (Federation of German Banks survey finding that holdings of ten largest private

and both economies show signs of slowing,[244] the gap in the cost of capital, which is so disadvantageous to U.S. corporations, seems unlikely to close in the near future.[245] This does not bode well for the expansion of U.S. capital investment since the cost of capital is central to determining the net present value of firms' investment projects.[246] Indeed, some U.S. firms may have restructured specifically to use debt[247] and to reduce existing investment programs entailing high capital costs.[248] Under our current system, firms will continue to be driven toward using relatively costly "external finance" for investment and the high interest rate will "cut both the level and the *horizon* of . . . investment."[249] Indeed, the higher the

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banks in aggregate equity of all German stock corporations declined from 1.32% in 1976 to 0.57% in 1989); Esser, *supra* note 230, at 22-23 (noting that the credit dependence thesis is undermined by the availability of offshore credit, large industrial firms' high rate of self-financing, and reduced debt owed to banks by the leading export centers of the German economy).

244. *See supra* notes 197 and 224, 237.

245. As McCauley and Zimmer, *supra* note 186, at 24, observe, "[t]he prospects advise against waiting and hoping for demographic and consumer borrowing trends to improve the U.S. position." *Id.*

246. *See* HALL, INVESTMENT HORIZONS, *supra* note 6, at 20, 34; Grundfest Remarks, *supra* note 153; Gilson & Kraakman, *Outside Directors*, *supra* note 10, at 882 n.68.

247. It would be tempting to conclude that Japan's relatively higher rate of corporate leverage accounts in part for its relatively lower cost of capital, and that increases in corporate leverage would result in lowering of those costs for U.S. corporations. However, Japanese and German corporations enjoy dramatically different relationships with their banks than do U.S. corporations, which allow them to increase leverage with relatively low costs of financial distress. *See supra* notes 202-42 and accompanying text; McCauley & Zimmer, *supra* note 186, at 21-22. By contrast, U.S. corporations that increase their leverage suffer substantially increased risk of bankruptcy. *See id.* at 23 (10% rise in U.S. leverage associated with 29% increase in fraction of corporate debt in bankruptcy). *But see supra* notes 136, 224 (indicating that the rate of bankruptcies in Japan is increasing). It would seem, then, that the potential for decreasing the cost of capital through increased leverage is at best "limited" given the nature of U.S. corporate debtor-creditor relationships.

248. HALL, INVESTMENT HORIZONS, *supra* note 6, at 20, 34. *See also* Landau & Hatsopoulos, *supra* note 152, at 604 (concluding that recent costs of capital to U.S. corporations sometimes exceeded returns).

249. HALL, INVESTMENT HORIZONS, *supra* note 6, at 35. Professor Hall concludes that, if corporate restructuring discourages investment, "it does so by increasing the cost of funds to the firm in order to force managers to pay out cash, and not by a change of control alone." *Id.* at 34. Results of her statistical analysis and case studies indicated that "the most nega-

cost of capital (either debt or equity), the higher the discount rate for future returns will be; accordingly, future benefits from investment must be projected at still higher levels in order to justify present investment. The final result will be still less investment over the long term, and the continued decline in the competitiveness of U.S. firms in world markets.

B. *The Problem of Labor Noncooperation*

Plant closings and staff reductions that often follow in the wake of takeover contests and corporate restructurings may be essential for the sake of efficiency and firm profitability. Nevertheless, they impose costs on the affected employees (and communities) that may well justify transfer payments to cushion transition to new jobs (or communities).[250] The central question relative to competitiveness is whether a firm's long-term performance may be harmed by disregarding employee interests when plants are closed and staff levels are trimmed in order to effect quick improvements in share price.

1. Broken Promises?

Although anecdotal accounts abound,[251] the empirical data to date on whether the takeovers and defensive restructuring of the 1980s resulted in significant employment losses and wage reductions are inconclusive. Some studies suggest that white collar and administrative personnel were principally affected, job losses amounted to about a ten to fifteen percent reduction in staff levels, and that employment levels tended to rise again during the post-transaction period.[252] Other studies

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tive event for investment is the defense of a hostile takeover," although friendly takeovers between firms in related industries often were not followed by decreased investment. *Id.* at 20.

250. *See, e.g.*, Marleen A. O'Connor, *Restructuring the Corporation's Nexus of Contracts: Recognizing a Fiduciary Duty to Protect Displaced Workers*, 69 N.C. L. REV. 1189 (1991); Alan E. Garfield, *Helping the Casualties of Creative Destruction: Corporate Takeovers and the Politics of Worker Dislocation*, 16 J. CORP. L. 249 (1991).

251. For a haunting Pulitzer Prize-winning account of the human costs of a leveraged buyout, see Susan C. Faludi, *Safeway LBO Yields Vast Profits But Exacts a Heavy Human Toll*, WALL ST. J., May 16, 1990, at A1. *See also* Shleifer & Summers, *supra* note 142, at 48-50 (stating that employee wage reductions in TWA takeover equalled one and one-half times takeover premium paid to shareholders).

252. *See, e.g.*, Sanjai Bhagat et al., *Hostile Takeovers in the 1980s:*

offer a considerably gloomier picture.[253]

Measuring the impact of takeovers and restructurings on employment is difficult given the various causes of staff reductions. A workforce reduction may be prompted by a decline in market demand for a firm's product.[254] Another firm may reduce its workforce in the wake of a defensive restructuring in response to a real or threatened hostile takeover.[255]

There are two basic, distinct rationales offered to justify terminating employees or reducing wages and benefits because of pressures from the market for corporate control. The positive, efficiency-enhancing rationale states that the firm was undertaking long-needed reductions in a bloated staff and overly-generous compensation packages—reductions that management, unresponsive to shareholder welfare, had been reluctant to implement. In this view, the takeover threat operates to force managers to reduce unnecessary labor costs and, in the process, improve profitability and share price. If the managers

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The Return to Corporate Specialization, *in* BROOKINGS PAPERS ON ECONOMIC ACTIVITY: MICROECONOMICS 1, 26, 29 (1990) (layoffs principally of white collar employees); Charles Brown & James L. Medoff, *The Impact of Firm Acquisitions on Labor*, *in* CORPORATE TAKEOVERS, *supra* note 142, at 9, 10-11, 23 (only 5% decline in employment after sale of assets but wages were about 5% higher; study limited to companies in a single state); Steven Kaplan, *The Effects of Management Buyouts on Operating Performance and Value*, 24 J. FIN. ECON. 217, 240-42 (1989) (employment growth rate 6-12% lower in companies taken-over during 1980-86 period, compared to similar companies not taken over); Frank R. Lichtenberg & Donald Siegel, *The Effect of Ownership Changes on the Employment and Wages of Central Office and Other Personnel*, 33 J. L. & ECON. 383, 401-02 (1990) (noting that "ownership change is associated with sharp reductions in the *firm's* employment of auxiliary-establishment personnel, relative to its employment of production-establishment personnel," employment of workers in production plants that changed ownership during 1977-82 period was 7-13% lower than in plants that did not change owners; there is evidence of partial recovery of employment level during post-transaction period); *see also* Leveraged Buyouts: Case Studies of Selected Leveraged Buyouts, Report of the G.A.O., B-244418, Sept. 16, 1991, at 5 (noting an employment decline after four LBOs and one recapitalization caused by asset divestitures and cost reduction efforts) [hereinafter GAO Report].

253. *See, e.g.*, Shleifer & Summers, *supra* note 142, at 33-56.

254. *But see infra* notes 268, 288-90 and accompanying text (Japanese firms confronting declining markets explore new ventures and retain or lend regular employees to subsidiaries/customers because of a strong traditional inhibition against layoffs).

255. The demonstration effects of takeovers also cannot be directly measured. *See supra* notes 115, 137 and accompanying text.

still refuse to act, shareholders will tender their shares and the new managers will make the necessary, if painful, adjustments.

According to the second rationale, the firm is interested in attracting employees who will make a career-long commitment; its focus is on developing an "internal labor market." The firm benefits because the employees will develop skills, over the course of their careers, that will make a greater marginal contribution to the value of the firm's product than the firm could obtain from workers hired periodically from the external labor market, who have no prior involvement with the firm. These are "firm-specific" skills; they improve the employee's productivity for the particular firm but are not transferable general skills that would offer similar value to other employers.[256] The firm is also interested in encouraging the cooperation of existing employees in training new workers to develop such skills without fear that such cooperation will result in their own replacement. A firm secures this type of commitment from its employees in large part by promising that layoffs will occur in inverse relationship to length of service, and by keying compensation and benefits to length of service. Accordingly, a significant portion of employee compensation is deferred to the latter stages of an employee's career. Employees agree *ex ante* to such delayed-compensation arrangements presumably because they will receive more valuable lifetime compensation (including job satisfaction and job security) than if they remain in the external labor market.[257]

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256. *See* PETER B. DOERINGER & MICHAEL J. PIORE, INTERNAL LABOR MARKETS & MANPOWER ANALYSIS 13-20, 32-40 (1971) (defining general and firm-specific skills). For a similar analysis of the employment relationship, see OLIVER E. WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM 248-49 (1985).

257. A stylized graphic description of this deferred-compensation scheme can be found in Michael L. Wachter & George M. Cohen, *The Law and Economics of Collective Bargaining: An Introduction and Application to the Problems of Subcontracting, Partial Closure and Relocation*, 136 U. PA. L. REV. 1349, 1355-77 (1988). Professor Lazear offers a somewhat different account of similar compensation arrangements. *See* Edward P. Lazear, *Agency, Earnings Profiles, Productivity, and Hours Restrictions*, 71 AM. ECON. REV. 606 (1981) [hereinafter *Earnings Profiles*]; Edward P. Lazear, *Why is There Mandatory Retirement?*, 87 J. POL. ECON. 1261 (1979) [hereinafter *Mandatory Retirement*]. In Professor Lazear's view, compensation is structured in this way in order to minimize shirking by employees whose performance cannot be closely monitored. For employees

Outside of the union sector (approximately 15% of the private nonagricultural workforce), these arrangements are based on implied promises, in part because of the difficulty of negotiating all of the terms of a career-long relationship.[258] However, the employer may behave opportunistically once the backloaded portion of the employee's deferred compensation begins. At this stage, the employee is being paid more than her marginal productivity to the firm (and more than she could obtain in the external labor market). Employers ordinarily honor such implied agreements because of what economists call reputational costs; opportunistic employers would be unable to persuade new workers to enter into such arrangements and would risk demoralizing the existing workforce, inviting quits and shirking.

Reputational costs are significantly lower, however, among firms that are leaving product markets or relocating to other areas of the country. Moreover, such costs may not concern the new owners who, after all, made no commitments to the affected employees. For the raider or the managers of a firm fearing a potential takeover, the incentive to renege on such implied contracts may be irresistible, since labor accounts for about 70% of total costs.[259]

In such situations, staff reductions and wage and benefit cuts may show up as improvements in share price, but at the

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compensated in this manner, the costs of a termination before they have received their backloaded compensation are particularly high, and they therefore are less likely to shirk. *See Earnings Profiles*, *supra*, at 615-18; *Mandatory Retirement*, *supra*, at 1266.

258. *See, e.g.*, Oliver E. Williamson et al., *Understanding the Employment Relation: The Analysis of Idiosyncratic Exchange*, 6 BELL J. OF ECON. 250-80 (1975). Professor Stone argues that even unions face difficulties negotiating enforceable contracts to protect expectations arising from internal labor market arrangements. *See* Stone, *supra* note 44, at 56.

259. Alan S. Blinder, *Introduction*, *in* PAYING FOR PRODUCTIVITY: A LOOK AT THE EVIDENCE 1, 2 (Alan S. Blinder ed., 1990). *See also* Shleifer & Summers, *supra* note 142, at 36 ("Since firms' labor costs far exceed their profits and since even poor capital investments yield some returns, very small differences in firms' success in extracting rents from workers . . . are likely to be much more important in determining market value than the differences in corporate waste associated with differences in firms' volume of reinvestment."); *cf.* Coffee, *supra* note 44, at 446 (modeling takeovers as efficient breach of implied contracts with middle managers); Coffee, *Shareholders Versus Managers*, *supra* note 18, at 73-76 (discussing the effects of managers' efforts to protect their own deferred compensation).

cost of violating implied contracts.[260] Aside from the impact on the affected employees, such employer opportunism impairs *ex ante* efficiency in two ways. First, it reduces the willingness of new employees to enter into such deferred-compensation arrangements (though otherwise attractive to them); second, it may result in difficult-to-monitor reductions in performance levels by existing employees. As Professors Shleifer and Summers observe, "the ability to enter into implicit contracts and to be trusted to abide by them may be one of the most valuable assets owned by shareholders. Takeovers may substantially reduce the value of these assets."[261] Moreover, "the scope of fear of trust" will spread to other firms and limit contracting opportunities there as well.[262]

Which explanation is more plausible? The first version may be persuasive in sheltered product markets where managers have overpaid workers and maintained unnecessary workers without fear of market discipline.[263] But where barriers to entry into product markets are relatively low, could managers long engage in unnecessary high labor cost policies?

2. Other Consequences of Distrust.

Disregard of employee concerns by managers focused on the short term may have further negative consequences for the performance of U.S. firms. First, managers who are preoccupied exclusively with realizing short-term gains for shareholders will have difficulty securing the trust of employees with respect to the flexibility of compensation. In both union and non-union firms, workers in this country, as compared to their counterparts in Japan and Germany,[264] resist variable pay

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260. *See* Shleifer & Summers, *supra* note 142, at 41 ("As the incumbent managers are removed after the takeover, control reverts to the bidder, who is not committed to upholding the implicit contracts with stakeholders. Shareholders can then renege on the contracts and expropriate rents from the stakeholders. The resulting wealth gains show up as the takeover premia.").

261. *Id.* at 46.

262. *Id.* at 46-47. *See infra* notes 275-90 and accompanying text (contrasting U.S. labor relations with those of Germany and Japan.)

263. This is the gist of Professor Williamson's commentary on the Shleifer-Summers article. *See* Oliver E. Williamson, *Comment*, *in* CORPORATE TAKEOVERS: CAUSES AND CONSEQUENCES 61 (Alan J. Auerbach ed., 1988).

264. *See, e.g.*, Freeman & Weitzman, *Bonuses and Employment in*

and profit-sharing arrangements. Managers thus face difficulties in keying compensation to firm performance, with negative consequences for productivity. "We now pay workers not for *output* produced," Professor Blinder writes, "nor even for labor *input* provided, but simply for *time* spent on the job."[265] Employees' level of trust and sense of participation in the enterprise may determine their receptivity to performance-based pay.[266]

Second, when workers become demoralized and do not share a common sense of enterprise with their managers, productivity may be negatively affected in ways that are difficult to monitor and measure. This may be reflected in the quality of the product as well as lower labor productivity figures. Dean Lester Thurow has called for a "producer economics" to combat this American malaise.[267] Managers who demonstrate no commitment to their employees may be unable to persuade them to work harder (and more creatively) for the welfare of the firm when demand for the firm's products falls.[268]

Finally, the spirit of distrust pervades the system of U.S. labor relations. It is now more than fifty years since the enactment of the basic labor law in 1935, and American unions and managers remain in a pitched battle that has yielded bitter strikes, rigid contracts, and a shrinking union sector. Both

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Japan, 1 J. OF THE JAPANESE & INT'L ECONOMIES 168-94 (1987) (approximately 1/3 of annual compensation is in form of performance-based bonuses). *But see* Masahiro Okuno, *Corporate Loyalty and Bonus Payments: An Analysis of Work Incentives in Japan*, *in* THE ECONOMIC ANALYSIS OF THE JAPANESE FIRM 387, 387 (Masahiko Aoki ed., 1984); Jan Svejnar, *Relative Wage Effects of Unions, Dictatorship and Codetermination: Economic Evidence from Germany*, 63 REV. OF ECON. & STAT. 188, 189 (1981) (works councils negotiate plant-by-plant variances from industry-wide agreements).

265. Blinder, *supra* note 259, at 2.

266. *See, e.g.*, Daniel J.B. Mitchell et al., *Alternative Pay Systems, Firm Performance, and Productivity*, *in* PAYING FOR PRODUCTIVITY 15, 70 fig. 3 (Alan S. Blinder ed., 1990).

267. *See* Lester C. Thurow, Producer Economics Speech Before Indus. Rel. Res. Ass'n, New York, N.Y., December 1988); *see also* HARVEY LEIBENSTEIN, BEYOND ECONOMIC MAN: A NEW FOUNDATION FOR MICROECONOMICS 95-134 (1980).

268. Compare Ronald Dore's account of the reaction of Japanese managers to financial crisis, in RONALD DORE, FLEXIBLE RIGIDITIES: INDUSTRIAL POLICY AND STRUCTURAL ADJUSTMENT IN THE JAPANESE ECONOMY 1970-80 49 (1986) (noting that "[m]any Japanese firms allowed profits to fall or disappear, cut dividends and ran down assets for a year or two before they cut employment").

sides share the blame together with a deficient statutory scheme. However, for present purposes, it suffices to note that the stock market disfavors employee efforts to seek collective representation; managers aware of the risks of discounted share value may be inclined to break long-established collective bargaining relationships to the extent labor law permits them to do so. Since unions can play a beneficial role as the employees' voice within the firm[269] (indeed, they do so reasonably effectively in other countries),[270] here, too, is a lost opportunity for American companies.

III. TOWARD A SYSTEM OF BOUNDED MANAGERIALISM

As discussed above, we have increasingly witnessed the subordination of long-term business planning to the pursuit of short-term gains in the corporate sector. This article has suggested that, despite inevitable agency costs, as between managers and shareholders, managers are the business decisionmakers of choice. They are the corporate constituency most capable of synthesizing all available (as opposed to only public) material information and preparing a long-term plan for the corporate enterprise.

The approach of the current crop of "stakeholder" statutes, however, addresses only one side of the problem. By essentially freeing managers from the discipline of the market for corporate control, such laws should facilitate long-term investment decisions, but they also threaten to exacerbate the problem of wayward agents.[271] A coherent plan for reform requires that

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269. This is the message of an important book, RICHARD B. FREEMAN & JAMES L. MEDOFF, WHAT DO UNIONS DO? (1984).

270. *See infra* notes 286-90 and accompanying text.

271. Although, in general, anti-takeover statutes may facilitate long-term decisionmaking, laws that encumber proxy contests as a means of displacing incumbent management seem misconceived. *See, e.g.*, 15 PA. CONS. STAT. § 2572(A)(4) (1992) (stating that the statute's purpose is to "discourage . . . speculators from putting [the corporation] 'in play' through any means, including . . . threatening to wage or waging a proxy contest in connection with or as a means toward or part of a plan to acquire control of the corporation"). Proxy contests are disappointed shareholders' only alternatives to exit. By effectively silencing the voice option, these statutes exacerbate the liquidity perspective. Moreover, such statutes are unbalanced unless coupled with supplementary monitoring mechanisms to take the place of the diminished market for corporate control. *See infra* notes 332-417 and accompanying text.

the problems of agency costs be addressed through alternative monitoring mechanisms that can more effectively constrain managers without channeling their primary energies into short-term decisionmaking. A kind of "bounded managerialism" is needed—a state in which managers are secure enough to plan for and invest in the long term, while they remain ultimately accountable to the shareholders and other corporate constituencies they represent.[272] The following offers some suggestions for change in existing laws and practices that might move us closer to such a system.

A. *False Starts*

1. Lessons from Abroad

As noted above,[273] the American economy and the American corporation are losing ground in the international marketplace. Germany and Japan have evolved significantly different approaches to corporate governance, finance and investment from our own.[274] At first glance, the most appealing option for our ailing economy would be to adopt *in toto* the successful practices of Germany and Japan. Unfortunately, this is not a viable option. The core of Japan's *keiretsu* system or Germany's codetermination-*cum*-banker model capitalism cannot easily be transplanted to the U.S. under existing conditions.

First, the Japanese and German systems are based on harmonious labor-management relations, in which a high degree

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272. Martin Lipton and Steven Rosenblum have offered a provocative proposal for reform. *See* Lipton & Rosenblum, *supra* note 116. They suggest that the board of a public corporation be composed of a majority of independent directors and that all directors be elected for five-year terms, removable only for cause. These "quinquennial elections" are to be based on five-year reports independently evaluated by an outside advisor who will critique the corporation's performance in the prior five years. Hostile takeovers would not be allowed in the years between board elections. *Id.* at 225.

While facilitating a somewhat longer time-frame for managerial decisionmaking (five-year, as opposed to one-year, terms) this proposal, too, is subject to the criticism that it "merely recreates the episodic, all-or-nothing monitoring originally sought to be eliminated." Gilson & Kraakman, *Outside Director*, *supra* note 10, at 882 n.68. Nevertheless, since Lipton and Rosenblum's proposal also keys executive compensation directly to the success or failure of the corporation's five-year goals, it represents a useful step toward creating incentives for the long term. *See infra* notes 395-413 and accompanying text.

273. *See supra* notes 151-84 and accompanying text.

274. *See supra* notes 185-201 and accompanying text.

of trust permits labor to participate in corporate governance and agree to flexible work arrangements and variable wages keyed to firm performance.[275] By contrast, the U.S. system is predicated on an adversarial model of labor-management relations, characterized by chronic hostility and distrust.[276] For a variety of reasons, including but not limited to the continued hostility of American management (as well as many workers) to union representation, the percentage of American workers in the private sector represented by unions continues to decline. It is now at a level approaching the union density rate of the pre-New Deal period.[277] This, in turn, contributes to institutional insecurity and dogged insistence by unions on maintaining wages, benefits and restrictive work rules that place the union-represented company at a distinct competitive disadvantage within the industry.[278] Moreover, federal law governing collective bargaining itself erects formidable barriers between workers and managers.[279]

In the ever-growing nonunion sector, most American workers are employed "at will"—absent a contract or statutory rule to the contrary, they can be fired at any time for any reason or no reason at all.[280] The prevailing attitude conceives of labor

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275. For an informative comparative overview of systems of labor relations, see Clyde W. Summers, *Comparative Perspectives*, *in* LABOR LAW AND BUSINESS CHANGE: THEORETICAL AND TRANSACTIONAL PERSPECTIVES 139 (Samuel Estreicher & Daniel G. Collins eds., 1988). The Japanese system is usefully analyzed in Masanori Hashimoto, *Employment and Wage Systems in Japan and Their Implications for Productivity*, *in* PAYING FOR PRODUCTIVITY 245-94 (Alan S. Blinder ed., 1990).

276. *See supra* notes 264-70 and accompanying text.

277. The extent to which employer opposition is a principal cause of the decline of U.S. labor density is a subject of considerable debate. *Compare* Henry S. Farber, *The Decline of Unionization in the United States: What Can Be Learned from Recent Experience?*, 8 J. LAB. ECON. S75 (1990); Paul Weiler, *Promises to Keep: Securing Workers' Rights to Self-Organization under the NLRA*, 96 HARV. L. REV. 1769 (1983), *with* Leo Troy, *Will a More Interventionist NLRA Revive Organized Labor?*, 13 HARV. J. L. & PUB. POL'Y 583 (1991); Robert J. LaLonde & Bernard D. Meltzer, *Hard Times for Unions: Another Look at the Significance of Employer Illegalities*, 58 U. CHI. L. REV. 953 (1991).

278. *See, e.g.*, Peter D. Linneman et al., *Evaluating the Evidence on Union Employment and Wages*, 44 IND. LAB. RELS. REV. 34-53 (1990).

279. Employees who have a role in policy making or policy implementation are deemed to be "aligned" with management and excluded from the protection of the labor laws. *See, e.g.*, NLRB v. Yeshiva University, 444 U.S. 672, 680-90 (1980) (holding the university faculty was "aligned").

280. Legislation prohibits terminations on account of race, gender, reli-

as a service to be purchased when needed and discarded when the need no longer exists. As one commentator has observed, "past service creates no future obligations."[281] Astonishingly, federal labor law actually prohibits nonunion firms from establishing in-house employee representation arrangements.[282] However, despite the urging of labor law scholars,[283] a fundamental overhaul of U.S. labor relations does not appear to be in the offing.

Secondly, with regard to national industrial and investment policy as a whole, the United States is characterized by the absence of influential and active private financial institutions operating within and upon the corporate sector. The Federal government resists formalized involvement in the affairs of private enterprises except under the most extraordinary circumstances.[284] Moreover, banks and other financial institutions that provide working capital and might be likely sources of guidance for business enterprises, are discouraged (and frequently legally prohibited) from meaningful participation in corporate affairs.[285]

Contrast these American norms with the practices that prevail in Germany and Japan. In terms of labor-management relations, German codetermination, far from separating or alienating labor from management, achieves a high degree of formalized labor-management cooperation, and considerable trust and voluntary informational exchange.[286] Unlike Ameri-

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gion, national origin, age or union membership, and the state courts have struggled to expand contractual and tort doctrine to provide some redress for unjust terminations. *See, e.g.*, PAUL C. WEILER, GOVERNING THE WORKPLACE: THE FUTURE OF LABOR AND EMPLOYMENT LAW 48-104 (1990).

281. Summers, *supra* note 275, at 141; *see also* PHILIP SELZNIK, LAW, SOCIETY AND INDUSTRIAL JUSTICE 134-36 (1969) (discussing implications of "contract at will" relationship).

282. WEILER, *supra* note 280, at 212.

283. *See, e.g.*, *id.* at 205-18.

284. Few have bemoaned the state's nonintervention in the past. *But see* Reich & Donahue, *supra* note 227, at 286-287 (stating that, given the successful federal intervention over several years on behalf of Chrysler Corporation, "[i]n a nation in which the incompetence and commercial innocence of federal bureaucrats are assumed as a matter of course, this record merits attention").

285. *See infra* notes 374-94 and accompanying text.

286. *See, e.g.*, Alfred F. Conard, *Corporate Constituencies in Western Europe*, 21 STETSON L. REV. 73, 78-80 (1991); Vagts, *supra* note 234. *See also supra* notes 275-76 and accompanying text.

can unions that compete for an ever-shrinking organized workforce, German unions enjoy institutional security and represent a workforce with considerable union density. Wages are uniformly determined at a supra-enterprise level; local bargaining with enterprise works councils, which typically transpires without strikes, concerns additional incentive compensation less likely to render individual firms uncompetitive.[287] Similarly, the Japanese system is based on a relational model of worker-manager cooperation,[288] flowing from a strong cultural tradition of inter-personal commitment,[289] in which firms assume what amounts to a lifetime obligation towards employees and expect (and apparently receive) an equivalent sense of loyalty and commitment in return.[290]

There are also important differences in terms of governmental or private financial institutions' involvement in shaping and supporting a national industrial policy. The Japanese government, for example, intervenes actively to shape industrial policy;[291] state intervention influences the cost of capital in both countries.[292] Equally (if not more) important, in both Germany and Japan financial institutions—particularly banks—play a critical role both as equity holders and active

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287. *See, e.g.*, Aoki, *supra* note 17, at 160; Manfred Weiss, *Recent Trends in the Development of Labor Law in the Federal Republic of Germany*, 23 L. & SOC'Y REV. 759, 766-67 (1989).

288. *See, e.g.*, Hashimoto, *supra* note 275; DORE, *supra* note 268, at 77 (Japan uses system of "relational contracting" based on "voice and loyalty" rather than "exit and entry").

289. This is also evidenced by corporations' reciprocal ownership of each others' shares, which creates a pattern of "mutual obligation cementing" which functions as a "shareholding stabilization strategy" that effectively protects against hostile takeovers. DORE, *supra* note 268, at 70.

290. *See id.* at 72. The "quasi-fixed cost" imposed by this voluntary obligation, Dore suggests, creates a strong incentive for Japanese corporations to diversify. When the market for a particular product shrinks, the obligation to continue paying a workforce remains; there is, then, considerable incentive to diversify into another product line. Moreover, managers facing extremely limited opportunities for lateral promotions (corporations are suspicious of "defectors"), must pull their corporations up with them in order to advance their careers. *Id.*

291. *See, e.g.*, *id.*; *supra* notes 239-42 and accompanying text.

292. *Cf., e.g.*, Dore, *supra* note 268, at 127-129 (inflation controlled in important part because unions responded to government leadership and moderated demands for wages); *see also supra* notes 239-42 and accompanying text.

participants in corporate governance, a role that is essentially prohibited to their American counterparts under current U.S. law.[293]

All of these factors demonstrate the impracticality of attempting to graft either the German or the Japanese system onto the United States corporate sector.[294] Although certain elements of these systems could (with effort) profitably be introduced into the United States,[295] we would be well advised to look closer to home for reforms that can begin to increase productivity and competitiveness both in the near future and over the long term.

2. LBO Associations

The relatively recent phenomenon of the "LBO Association,"[296] is often praised for its ability to bridge the separation of ownership and control,[297] thereby decreasing agency costs and producing efficiency gains.[298] Indeed, Professor Jensen, an outspoken supporter of LBOs and other "going private" transactions, has suggested that we may be experiencing the "eclipse" of the public corporation by these better, more efficient vehicles for the investment of capital.[299]

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293. *See supra* notes 224-38 and accompanying text.

294. Some commentators have suggested that the Japanese system is becoming more like the U.S., rather than the other way around, as the *keiretsu* system is eroded by the development of new capital markets and regulations limiting banks' equity positions in client companies. *See, e.g.*, Jensen, *Eclipse*, *supra* note 5, at 73; *supra* notes 232-36 and accompanying text. Professor Roe offers a somewhat different explanation: the concentration of financial power may be incompatible with a mature political democracy. *See* Roe, *supra* note 117, at 65 n.206.

295. *See infra* notes 232-36 and accompanying text.

296. For the purposes of this article, the LBO Association is a corporation, financed primarily by private and public debt, rather than equity. Its owners (typically an LBO partnership) are institutions rather than individuals; its managers are also owners having relatively large equity interests. Such an organization has no public shareholders and its shares are (at least initially) not listed or traded on national security exchanges. *See* Jensen, *Eclipse*, *supra* note 5, at 61.

297. *See, e.g.*, *id.* at 66. It would be more accurate, however, to describe the LBO structure as eliminating the separation of ownership from control through the replacement of outside equity with debt. *See* Gilson & Kraakman, *supra* note 74, at 877; *see also supra* notes 137-40.

298. Gilson & Kraakman, *supra* note 74, at 41; Jensen, *Eclipse*, *supra* note 5 at 66-67; Kaplan, *supra* note 252.

299. Jensen, *Eclipse*, *supra* note 5, at 61.

Despite the success of some (though by no means all) LBO transactions,[300] even Professor Jensen concedes that the unavoidably high levels of indebtedness that are the defining characteristic of LBOs will be suited only to certain industries, such as cash-rich low-growth industries, generating more cash than they can profitably invest.[301] For these industries, the discipline of substantial indebtedness may prevent managers from retaining free cash flow that might more profitably be invested elsewhere.[302] However, for growth industries where profitable investment opportunities exceed internally generated cash, the LBO Association is not a viable option, since available cash flow will not, typically, support both these costly though potentially profitable investment strategies and the repayment of substantial debt service.[303]

Even in growth industries, Professor Jensen suggests, it may be possible to draw on the LBO experience and reduce waste. Public corporations could, for example, borrow in order to pay out dividends, thus intentionally subjecting themselves to the discipline of increased indebtedness. They can further improve the alignment of managers and public shareholders by either requiring substantial equity ownership by managers and other

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300. *See, e.g.*, GAO Report, *supra* note 252, at 6-7 (noting that the companies studied enjoyed "varied" financial performance after LBOs or recapitalization). This report examined five case studies: Revco D.S. Inc.; Safeway Stores Inc.; Allied Stores Corporation; Federal Department Stores Inc., and Phillips Petroleum's recapitalization to avoid an LBO. Since the LBOs occurred, Allied, Federated and Revco have all filed for bankruptcy protection under Chapter 11. Safeway, after a period of adjustment has improved its performance; Phillips' profitability initially fell, and has continued to fluctuate. *Id.*

301. Professor Jensen includes in this group industries such as automobile tires, steel, chemicals, tobacco, TV/radio broadcasting, automobiles, aerospace technologies, etc. Jensen, *Eclipse*, *supra* note 5, at 64.

302. Professor Roe suggests that the LBO may serve as a monitoring intermediary for financial institutions fragmented by regulation. Roe, *supra* note 117, at 62-63. Since the legal framework prevents direct monitoring by financial institutions holding equity control, LBO Associations can obtain debt and equity funding from these disabled financial institutions, and directly monitor on their behalf. *Id.* at 63. However, any approach that hopes to increase efficiency by involving financial institutions should consider a more direct attack on the disabling rules themselves. *See infra* notes 317-24, 374-94 and accompanying text.

303. In such industries, a high level of indebtedness would likely interfere with the ability to make necessary capital investments, such as adequate levels of R&D spending.

employees, or creating management compensation plans based on performance (measured by cash flow and value rather than the more manipulable measure of earnings).[304]

High levels of indebtedness are neither always beneficial nor sustainable, however. Not surprisingly, the unusually high level of debt[305] that burdens an LBO Association creates an increased risk of financial failure.[306] Despite this increased risk, there is little reason to expect the LBO Association to exhibit increased caution, since its owner-managers frequently invest no more than 10-15% of their own equity in the transaction.[307] The owner-managers are not the primary debtholders; they are the big equity holders. Indeed, as the LBO Association becomes more heavily leveraged, the remaining equity begins increasingly to resemble a call option. With so little personal wealth invested, and limited shareholder liability, the risk of bankruptcy falls overwhelmingly on the creditors who supplied the lion's share of capital. In effect, the LBO partnership has purchased an option on the enterprise for a small percentage of the total cost. If its value does not exceed its liabilities, the LBO partnership loses only the cost of the option. Such a financing arrangement is unlikely to encourage caution or attract patient capital.[308]

At the time of Professor Jensen's 1989 article, the LBO transactions of the early 1980s had not been overtaken by a succession of extraordinary bankruptcies that highlight the adverse consequences of excessive indebtedness.[309] Moreover,

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304. Jensen, *Eclipse*, *supra* note 5, at 72. For further discussion of executive compensation, see *infra* notes 395-413 and accompanying text.

305. While German and Japanese corporations typically carry still higher levels of indebtedness than those that prevail in U.S., the risk of bankruptcy is considerably higher in the U.S. *See supra* notes 202-38 and accompanying text.

306. *See also* Kaplan and Stein's recent study of 124 large management buyouts completed between 1980 and 1989. STEVEN N. KAPLAN & JEREMY C. STEIN, THE EVOLUTION OF BUYOUT PRICING AND FINANCIAL STRUCTURE 34 (National Bureau of Economics Working Paper No. 3695, 1991 (noting that "[t]he buyouts of the late 1980s seem to be characterized by more of the theoretical pre-conditions for costly distress").

307. *See* Coffee, *Shareholders Versus Managers*, *supra* note 18, at 61.

308. *See id.* (moral hazards attach to high levels of debt where equity holder enjoys limited liability). Professor Jensen dismisses the moral hazard problem, suggesting that borrowers will consider the "reputational consequences" of too little caution, and creditors can protect themselves through *ex ante* negotiation. Jensen, *Eclipse*, *supra* note 5, at 70.

309. Floyd Norris, *Win or Lose, Buyouts Do It Big*, N.Y. TIMES, Jan.

bankruptcy is not the only risk that too much debt imposes on the corporate enterprise. Taking enterprises of considerable size (such as once-public corporations) "private," requires such high levels of indebtedness[310] that these newly "gone-private" corporations will rarely be able to maintain the cash flow needed for productive capital investment such as R&D spending or expansion in growing markets.[311] Equally troubling is the fact that certain LBO transactions have been motivated primarily by the LBO Association's strong desire to "do deals, rather than good deals" and to take their compensation in "front-end fees rather than in back-end profits earned through increased equity value."[312] The transactional "one-time-only" gains can be enormous, but the managers often leave behind a corporation staggering under its unmanageable debt load, headed either for bankruptcy or reincarnation as a public corporation. Such cyclic transactions are unlikely to lengthen the investment time horizon in the already short-term U.S. economy.

Finally, even assuming that substantial gains in efficiency were achieved in the 1980s in certain LBOs, LBOs by definition require plentiful and available credit—a financial climate

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28, 1992, at D1 (R.H. Macy filing for bankruptcy represents another leveraged buyout "gone bad."). *See also* Gary Weiss, *Financing the 90s*, BUS. WK., Nov. 4, 1991, at 113 (describing a wave of "deleveraging").

310. Jensen, *Eclipse*, *supra* note 5, at 69 (average debt-equity ratio in an LBO is 85%).

311. *See* Gilson & Kraakman, *supra* note 10, at 877 nn.50-51 (suggesting LBOs are likely to be a transitory phenomenon). Empirical studies also indicate that LBOs have not typically occurred in industries that engage in significant R&D expenditures. *See supra* notes 173-78 and accompanying text.

312. Jensen, *Eclipse*, *supra* note 5, at 74. *Cf.* George Anders, *LBO Odyssey: Playtex Goes Through 4 Buy-Outs Since 1985, Enriching Top Officer*, WALL ST. J., Dec. 17, 1991, at 1 (CEO received $186.5 million from four successive buyouts of Playtex; his initial personal equity investment was $5.5 million; corporate product market share and product development declined).

LBO transactions frequently involve only a temporary "gone private" hiatus from public corporate status, since managers who have taken firms private through LBOs, may sometimes "overinvest temporarily . . .; but the costs of holding such an expensive and undiversified investment predictably make this a short-term investment." Coffee, *Shareholders Versus Managers*, *supra* note 18, at 36 (managers later either reduce leverage by selling assets or by issuing new public equity after the takeover threat has been removed). *See also* Janet Sterngold, *Wall Street Buys Into the Action*, N.Y. TIMES, June 19, 1986, at D1.

that predominated in the U.S. through the 1980s but that has dramatically shifted in the belt-tightening 1990s. It will no longer be possible (if it ever was, given the limited viability of the LBO structure) to look upon the LBO Association as the *deus ex machina* that will save us from our economic woes. Indeed, at this time, when public equity offerings have again begun to compete with debt to provide the bulk of externally generated corporate capital,[313] it seems clear that the public corporation is here to stay. It is the public corporation itself and its surrounding legal landscape that needs re-examination and constructive renovation in the quest for long-term industrial recovery.

3. Empowerment of Institutional Shareholders

Many who deplore the managerialist model look to institutional shareholders for more effective oversight—even control—of corporate decisionmaking.[314] If shareholders were in control, directors would really monitor managerial decisionmaking and managers would not deviate from their pursuit of shareholder wealth. The problems of retained free cash flow would be corrected. Executive compensation would be rationalized and based on corporate performance rather than growth.[315]

Those who hope for increased activism among public shareholders usually recognize the challenge of attempting to motivate and empower any group of actors so fragmented and widely dispersed. Indeed, passivity has traditionally been acknowledged to be a sensible investment posture for shareholders who rationally weigh the costs (which those who monitor bear in full) against the benefits (which those who monitor must share with all other shareholders).[316]

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313. Until credit began to dry up generally, there were relatively few public issues. *See* Stout, *supra* note 82, at 647 nn.185-186. Debt seemed a preferable source of capital since interest payments are (and dividend payments are not) a deductible business expense for the corporation. Moreover, equity issues are not inexpensive, since underwriters' commissions and other fees may cost the corporation up to 15% of the total proceeds. *Id.* at 661 & n.252.

314. *See generally* Black, *Shareholder Passivity*, *supra* note 10,; Black, *Agents Watching Agents*, *supra* note 10; Coffee, *Liquidity Versus Control*, *supra* note 83; Gilson & Kraakman, *Outside Director*, *supra* note 10.

315. *See, e.g.*, Dent, *Unifying Ownership and Control*, *supra* note 10, at 911-15.

316. *See supra* notes 117-25 and accompanying text.

Recently, however, some corporate scholars have observed that passivity may really be the result of multiple regulations that have the effect (if not the intent) of preventing concentrated ownership and control by financial institutions. This complex network of legal barriers, briefly referred to above and exhaustively described elsewhere,[317] will not be rehearsed in detail here. At bottom, however, these rules reveal a consistent model of "legitimate" corporate "investment" that is, almost by definition, passive and accepting of managerial primacy.[318] Accordingly, banks may not own shares directly and are limited to 5% ownership through bank holding companies.[319] Insurance companies are similarly limited in their equity ownership.[320] Public shareholders who communicate with each other about upcoming board elections or other corporate decisions risk classification as "proxy solicitors" who are subject to burdensome federal regulations.[321] Shareholders who purchase (or hold as a group) more than 5% of a corporation's shares are subject to Williams Act disclosure requirements.[322] Investors who purchase more than 15% or $15 million, whichever is less, of the shares of a public corporation must file with the Federal Trade Commission and the Department of Justice and pay a $20,000 filing fee or risk violating the Hart-Scott-Rodino Antitrust Improvements Act.[323] The message comes through loud

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317. *See supra* notes 117, 218-20 and accompanying text; Roe, *supra* note 117; Black, *Shareholder Passivity*, *supra* note 10; Coffee, *Liquidity Versus Control*, *supra* note 83.

318. For an interesting discussion of the inappropriate application of "controlling person" liability under the securities laws to activist institutional investors see Conard, *supra* note 10. Although it seems desirable to remove obstacles to benign collective institutional oversight (e.g., the nomination and election of representative directors), it has been suggested that the distinction between "the investment banker goat . . . [and] the institutional investor sheep . . . is not obvious at first glance." Richard M. Buxbaum, *Institutional Owners and Corporate Managers: A Comparative Perspective*, 57 BROOK. L. REV. 1, 24 (1991).

319. *See supra* notes 218-20 and accompanying text.

320. *See, e.g.*, CAL. INS. CODE §§ 1198, 1199 (West 1972) (prohibiting investment of more than 10% of capital and surplus in equity of any single company). *See also* N.Y. INS. LAW § 1405(a)(6), (8) (McKinney 1985 & Supp. 1990) (limiting investment in equity securities to 20% of insurer's assets, or one-half its surplus).

321. *See infra* notes 326 and accompanying text.

322. *See* Securities Exchange Act of 1934 § 13(d), codified at 15 U.S.C. § 78m(d) (1988).

323. 15 U.S.C. § 18a (1988); PUB. L. NO. 101-162, § 605, 103 Stat.

and clear: "investment" (at least in public corporations) does not encompass direct involvement in the operations of the enterprise. Under the present regulatory framework, appropriate public shareholder behavior is not likely to resemble "owner" behavior; it is limited to purchasing relatively small percentages of shares and voting almost exclusively on matters presented by management for consideration.

Of course, what the State has made, the State can unmake. These statutory and other limits on institutional ownership and activism can be loosened or even eliminated. However, there are reasons to doubt whether amendment or repeal of the regulatory strictures would, by itself, result in the constructively activist institutions some scholars envision.[324] Institutional shareholder passivity may result primarily from a number of "extra-legal" causes[325] that cast doubt upon the prospects for successful shareholder empowerment.

Most obviously, institutional shareholders typically lack the desire, expertise and long-term commitment to assume control of the corporations in which they invest.[326] Neither improved information and advice concerning governance issues,[327] nor

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988, 1031, as amended Pub. L. No. 101-302, 104 Stat. 217 (filing fee); 16 C.F.R. §§801-803 (1990) (FTC rules). There is an exemption for purchases up to 10% "solely for the purpose of investment" or purchases up to 15% or $25 million, whichever is greater, made by institutional investors "solely for the purpose of investment and in the ordinary course of business," or purchases made by public pension funds. However, the regulatory caveat, "solely in the purpose of investment," excludes any intention to participate in basic business decisions. According to FTC guidelines, such decisions include "(1) [n]ominating a candidate for the board of directors of the issuer; (2) proposing corporate action requiring shareholder approval; [and] (3) soliciting proxies . . . ." 43 Fed. Reg. 33,450, 33,465 (1978).

324. In fact, not all scholars agree that U.S. legal strictures are qualitatively or quantitatively more confining for institutional investors than regulations imposed on their more aggressive foreign counterparts. *See* Coffee, *Liquidity Versus Control*, *supra* note 83, at 1290-1317.

325. *Id.* at 241, 242-52. It is too simplistic to lump all institutional shareholders together, of course, since there are several different types of institutions, each with its own particular concerns. *See supra* notes 117-25 and accompanying text; *infra* notes 326-30 and accompanying text.

326. *See supra* notes 117-30 and accompanying text. *See also* MICHAEL JACOBS, SHORT TERM AMERICA 219-20 (1991) (urging the formation of "a new breed of investment firms whose approach is to make significant long-term investments in a limited number of companies" because institutional investors lack expertise to function as involved, active long-term investors).

327. Consider the work of organizations such as the Investor Respon-

lowered barriers to increased ownership and direct involvement will eliminate the "liquidity perspective" of institutional (and other) shareholders.[328] Shareholder decisionmaking during the takeover era reflects a deeply ingrained preference for an "exit"-driven investment strategy over a "voice"-driven strategy (even within the limits of the present regulatory structure). Certain institutions, most notably open-ended mutual funds, are particularly interested in liquidity because they may be called upon to cash out, on a daily basis, any customers choosing to sell. They therefore lack the incentive to become active long-term shareholders involved, at some cost,[329] in corporate governance issues. Many institutional shareholders lack long-term perspective because they focus continuously on short-term share values as indicators of their performance vis-a-vis other funds. Fund managers' success or failure is measured in terms of monthly or quarterly fund performance;[330] they are not, then, likely to take a broad

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sibility Research Center (IRRC), and the Analysis Group and Institutional Shareholder Services (ISS). *See* Regulation of Securityholder Communications, 56 Fed. Reg. 28,987 (proposed June 17, 1991) (to be codified at 17 C.F.R. § 240.14a-7) [hereinafter SEC Release 34-29315]. Professor Coffee observes that these organizations are really professional proxy advisors, and suggests that mandatory use of them as either advisors or delegates of voting authority would be a first step in ensuring that institutional voting decisions will be taken seriously by those who vote and by management. *See Liquidity Versus Control*, *supra* note 83, at 1354 n.301.

There are still regulatory wrinkles to be ironed out concerning the use of these professional proxy advisors. *Compare* Institutional Shareholder Services, Inc., SEC No-Action Letter, 1991 SEC No-Act, LEXIS 17, (Jan. 2, 1991) (advising ISS that Rule 14a-2(b)(2) contemplates exempting proxy advice rendered in the context of relationship with a general financial advisor, rather than specialized proxy advisory) *with* SEC Release No. 34-29315, at 28,990-92 (proposing Rule 14a-2(b)(1) exemption where proxy advice comes from "disinterested" person not seeking to obtain a proxy). SEC Release 34-29315 refers to "organizations or associations comprised of securityholders or issuers that exchange information with members regarding such matters of common concern as proxy voting positions or views on corporate governance policy. Another category would be providers of shareholder advisory services, including organizations [such as ISS, etc.] offering proxy voting information or recommendations . . . ." *Id.* at 28,991 (footnote omitted).

328. *See supra* note 324 and accompanying text.

329. Indexed funds confront another problem: how to become active and informed monitors of literally hundreds, if not thousands, of portfolio companies. Coffee, *Liquidity Versus Control*, *supra* note 83, at 1338, n.232; Lipton & Rosenblum, *supra* note 116, at 206.

330. Coffee, *Liquidity Versus Control*, *supra* note 83, at 1318-19, 1325

or long view of corporate governance issues.

Indeed, this liquidity perspective, if coupled with greater power and more direct influence within the corporation, may well worsen the serious problem of investment horizon for corporate managers. As noted above, although the market may efficiently evaluate public information concerning corporate decisionmaking, managers often have access to *non*public information that is withheld from the market.[331] Since some institutional shareholders are especially sensitive to fluctuations in share price, their influence may deter managers from taking appropriate bold and innovative risks and further inhibit long-term investment decisions.

B. *Supplementary Monitoring Mechanisms*

American public corporations currently operate in a state of legal equilibrium that places widely-dispersed and atomized shareholder-owners on one side of the balance and the managers they elect to represent them on the other. The managers are in charge, but they are vulnerable to short-term shareholder investment horizons. The shareholders are stripped of nearly all important ownership functions except the unlimited right to exit if unhappy, while denominated the monitors-of-choice over their elected agents. Despite the obvious impediments to meaningful shareholder monitoring, this system also disables or prohibits other interested and capable constituencies, most importantly banks[332] and labor,[333] from contributing their own perspectives on corporate decisionmaking that might aid in resolving the conflict between short-term interests and the long-term growth of the enterprise.

Until recently, the prevailing view was that this state of

& nn. 194-195 (noting that money managers seek short-term portfolio premiums despite recognition of greater profitability potential in a buy and hold philosophy); Altman Remarks, *supra* note 200, at 30 (noting that U.S. equity markets have become "totally dominated by performance-driven institutional investors of all kinds").

331. This may be the result of poor communication. If so, it is remediable. It is more likely, however, that managers choose to keep silent about proprietary information in order to avoid benefitting competitors. *See supra* notes 90-91 and accompanying text. If persuading the market would force managers to reveal confidential information, they must be able to risk silence.

332. *See supra* notes 218-20 and accompanying text; *infra* notes 374-94 and accompanying text.

333. *See supra* notes 276-93 and accompanying text.

affairs resulted from a sort of natural selection process that operates upon economic institutions as it does upon living species. Thus, the public corporation as currently constituted, whatever its limitations, was viewed as optimally efficient since it survived in its current form and not some other.[334] Recently, however, scholars have begun to re-examine the network of applicable laws and have realized that these laws determine the structure of corporate governance in much the way a street map evolves to shape the development of a community.[335]

The following is a discussion of suggested alterations to the corporate street map. These suggestions may contribute to the evolution of effectively bounded managerialism for American corporations.

1. Facilitating Relationship Investing

a. Shareholder-Nominated Directors

Although this article has suggested that the direct empowerment of institutional shareholders is a "false start," unlikely to extend the corporate investment horizon, a regime of unlimited managerialism would fare no better. While corporate managers must be secure enough to take appropriate actions in the long-term best interests of the corporation, they remain fiduciaries of the firm, subject to ongoing monitoring intended to ensure optimal performance of their fiduciary duties.[336]

Over the years, various reforms have been suggested, largely directed at reconfiguring the board of directors to provide for honest and impartial oversight of managerial performance.

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334. *See, e.g.*, Fama & Jensen, *supra* note 22, at 301 ("Absent fiat, the form of organization that survives in an activity is the one that delivers the product demanded by customers at the lowest price while covering costs."); *see also* Frank H. Easterbrook & Daniel R. Fischel, *Voting in Corporate Law*, 26 J.L. & ECON. 395, 416, 418 (observing that most efficient corporate law rules ultimately "survive").

335. *See generally* Roe, *supra* note 117; *supra* notes 317-23 and accompanying text.

336. This article does not offer a comprehensive analysis of "accountability." Such an analysis would require answers to all the ultimate questions that have plagued the debate over corporate governance: accountability *to whom*? (shareholders alone? other nonshareholder constituencies?), accountability *for what*? (short-term shareholder wealth maximization? employee welfare? the national economy?) and *in what time frame*? (short-term? long-term?).

Effective oversight by the board could narrow the separation between ownership and control,[337] and outside directors[338]—who are ostensibly without significant personal or business ties to senior corporate managers—increasingly populate the boards of most public corporations.[339] But, apart from the difficulty of remaining truly independent from a management that ultimately selects nominees to the board,[340] outside directors must look to management for their information, and they often lack the time to become expert in the corporation's affairs.[341] Since it is unclear whether outside directors, selected through the traditional proxy process, significantly outperform inside directors,[342] commentators continue to search for

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337. To that end, it has been suggested that even minority shareholders should always have board representation through cumulative voting. *See, e.g.*, Sanjai Bhagat & James A. Brickley, *Cumulative Voting: The Value of Minority Shareholder Voting Rights*, 27 J.L. & ECON. 339, 342 (1984).

338. *See, e.g.*, MELVIN ARON EISENBERG, THE STRUCTURE OF THE CORPORATION: A LEGAL ANALYSIS 170-185 (1976) [hereinafter STRUCTURE OF THE CORPORATION]. Professor Eisenberg has carried his vision forward as Chief Reporter of the American Law Institute's *Principles of Corporate Governance: Analysis and Recommendations*, ALI Project, *supra* note 33, recommending that the boards of all publicly held corporations "have a majority of directors who are free of any significant relationship with the corporation's senior executives," absent a single (or group) majority shareholder. *Id.*

339. It is not always clear whether a director can be considered a true "outsider." *See* STRUCTURE OF THE CORPORATION, *supra* note 338, at 144-146; Victor Brudney, *The Independent Director-Heavenly City or Potemkin Village?*, 95 HARV. L. REV. 597, 602-603 (1982) [hereinafter *Independent Director*]; Dent, *supra* note 10, at 898-99. Estimates therefore vary concerning both their numbers and effectiveness.

340. Although candidates are increasingly put forward by nominating committees, *see* ALI Project, *supra* note 33, at § 3A.04, nominees can be vetoed by the Chief Executive Officer, who typically retains enormous influence over board composition. *See* Dent, *supra* note 10, at 898; ROBERT CHARLES CLARK, CORPORATE LAW 105-108(1986); Harold Geneen, *Why Directors Can't Protect Shareholders*, FORTUNE, Sept. 17, 1984, at 28-29. *See also* Gilson & Kraakman, *Outside Director*, *supra* note 10, at 875.

341. *See* Brudney, *supra* note 339, at 609 n.38 (noting that the average outside director devotes only 122 hours per year to the position); STRUCTURE OF THE CORPORATION, *supra* note 338, at 141-144 (noting that most boards spend less than thirty-six hours a year meeting and that the "amount, quality, and structure" of information to which the board has access is "almost wholly within the control of the corporation's executives").

342. *See* Brudney, *supra* note 339, at 635 nn.101-103; Dent, *supra* note 10, at 900. *But see* Baray D. Baysinger & Henry N. Butler, *Corpo-*

improvements in the traditional director selection process.[343]

One recent proposal, by Professor George Dent, suggests vesting exclusive proxy control in a committee of the ten-to-twenty largest corporate shareholders.[344] This group would collectively nominate and solicit proxies for a *shareholder* slate of candidates for seats on the board, and the corporation would be required (either by federal statute or SEC rule) to pay for the solicitation.[345] Thus, incumbent directors would presumably have to please shareholders or risk being rejected for renomination. Of course, the management slate might still mount its own solicitation, but would have to pay for it without use of corporate funds.

Professors Eisenberg, Brudney and others have suggested affording substantial shareholders the opportunity to make nominations to the board.[346] Because shareholder-nominated

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rate Governance and the Board of Directors: Performance Effects of Changes in Board Composition, 1 J.L. ECON. & ORG. 101, 118-19, 121 (1985) (stating that boards consisting of both outside and inside directors perform most effectively).

343. Paradoxically, rather than render the board more accountable to shareholders, the presence of independent directors may immunize the entire board from liability. *See, e.g.*, Brudney, *supra* note 339, at 603 n.15 (outside directors approve of interested transactions). Moreover, outside directors are sometimes able to persuade courts to dismiss derivative actions against inside directors as against the best interests of the corporation. *See, e.g.*, Auerbach v. Bennett, 393 N.E.2d 994 (N.Y. 1979); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); CLARK, *supra* note 340, at 645-49.

344. Dent, *supra* note 10, at 907-15. Professor Dent's proposal would limit access to corporate treasury funds for proxy solicitation to these shareholders. These shareholders, in his view, would probably be the most knowledgeable about the firm and have the largest stake in its welfare. *Id.* at 907. The shareholders could be selected under guidelines established by the SEC, which would consider whether particular shareholders should be disqualified because of conflicts of interest. *Id.* at 907 n.146.

Lipton & Rosenblum have also recommended increasing the access of large shareholders to the proxy machinery. Their proposal, however, does not exclude incumbent managers from that process. *See* Lipton & Rosenblum, *supra* note 116, at 232.

345. Dent, *supra* note 10, at 910-11.

346. *See* STRUCTURE OF THE CORPORATION, *supra* note 338, at 16-18 (suggesting that large shareholders—those holding more than 5% of shares—should be allowed to nominate directors in the corporate proxy statement); Victor Brudney, *Fiduciary Ideology in Transactions Affecting Corporate Control*, 65 MICH. L. REV. 259, 284-85 (1966); Lipton, *supra*

directors might lose, Professor Lowenstein would reserve a certain percentage (20-25%) of board seats for shareholder-nominated directors.[347]

b. Professional Outside Directors

Professors Gilson and Kraakman urge the creation of a new species of director: the professional outside director.[348] Their proposed mechanism would involve delegating recruitment to an organization—a kind of clearinghouse—established and financed by a coordinated body of institutional investors. Because the clearinghouse would select and monitor these directors, they would not be specially dependent upon any particular shareholder. They would be dependent upon the overall satisfaction of institutional investors for their reappointment, and presumably faithful agents of these shareholders collectively.[349]

c. Shareholder Advisory Committees

In addition to the above proposals for proxy reform, certain large institutional investors have advanced a somewhat less formal arrangement for communicating shareholders' views to management: the shareholders' advisory committee.[350] Advisory committees could serve as general purpose "shadow" monitors,[351] attempting to fill the role outside directors are sup-

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note 3, at 67-69; *see also* Lipton & Rosenblum, *supra* note 116, at 231-32 (suggesting "free access [quinquennially] to the corporate proxy machinery" to any shareholders having 5% of outstanding shares or $5 million dollars aggregate market value of shares).

347. *See* Lowenstein, *supra* note 3, at 209-18.

348. *See* Gilson & Kraakman, *Outside Director*, *supra* note 10, at 883-92. These directors would be experts having the skills to effectively monitor corporate management. They would be well paid to make a full-time commitment to serve on the boards of as many as six public corporations.

349. This proposal is not free of difficulties, including problems of collective action, *see id.* at 887-88, directors' independence from shareholders as well as management, *see* Edward B. Rock, *The Logic and (Uncertain) Significance of Institutional Shareholder Activism*, 79 GEO. L.J. 445, 505 (1991), as well as the specter of group liabilities under the various federal rules discussed above, *see supra* notes 321-23 and accompanying text.

350. The committee proposal seems to have been adopted from the bankruptcy model, in which equityholders are permitted to form committees to represent their interests in Chapter 11 proceedings. *See* 11 U.S.C. §§ 1101-1174 (1988).

351. Rock, *supra* note 349, at 498.

posed to play on the board with even less information and fewer resources than available to conventional outside directors.[352] The committee might also function as a conduit for the shareholders' views to ensure that their concerns reach corporate directors on a regular basis. A third possibility would be the creation of targeted special-purpose committees, to assist in decisionmaking in those circumstances where the board is least likely to fairly represent shareholders' interests. For example, when directors face potential conflicts of interest, such as when certain directors are named as defendants in shareholder derivative actions,[353] a shareholder committee might have a clearer vision of the issues at stake than outside directors who are asked to decide whether to sue their fellow board members.[354]

d. Shareholder Proposals

At a time when the SEC is considering certain proposed

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352. *Id.*; Gilson & Kraakman, *Outside Director*, *supra* note 10, at 871-72.

353. *See, e.g.*, Auerbach v. Bennett, 393 N.E. 2d 994 (N.Y. 1979); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. Ch. 1984). In this context, the so-called "special litigation committee" (consisting of independent directors) always suffers from an inherent structural conflict concerning the potential litigation. Some courts find this conflict tolerable. *See, e.g.*, *Auerbach*, 393 N.E.2d at 1001-02. Others find it more problematic. *See, e.g.*, Alford v. Shaw, 324 S.E.2d 878 (N.C. App. 1985), *rev'd and remanded*, 358 S.E.2d 323 (N.C. 1987).

354. These limited advantages do not eliminate certain collective action problems with regard to participtions on such committees by particular institutions. For example, the free-riding problem exists here as in other collective action contexts. *See, e.g.*, Rock, *supra* note 349, at 496. Why should an institution contribute to the enterprise, i.e., serve on the committee, when it can wait and let others incur the costs? Of course, it is never clear that others will in fact step forward, particularly in the start-up period where there is no proven track record of benefits accruing to the institutions. Another serious problem for certain institutions is the potential loss of flexibility and greater legal exposure that might result from serving on the committee. Members might be subject to fiduciary duties to their fellow shareholders that would limit their ability to exit through trading in the corporation's shares. Although this might have the beneficial side effect of creating a long-term perspective for those temporarily "rooted" member institutions, it is not clear that all (or even many) institutions would be prepared to accept such constraints given their traditional preference for unconstrained liquidity.

amendments[355] to its proxy rules intended to "facilitate securityholder communications in furtherance of the goal of informed proxy voting,"[356] one issue has captured the attention of the public and the regulators: management compensation.[357] The SEC has adopted a new policy intended to permit shareholders (1) more complete and accessible information about executive compensation in their corporation[358] and (2) greater opportunity to express their views concerning executive compensation through shareholder proposals under Rule 14a-8.[359] Since the setting of management compensation levels is a matter traditionally committed to market forces and state corporation law,[360] the SEC initiative focuses not on the level or type of compensation, but rather on the complementary function of facilitating shareholder communications through the proxy process.[361]

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355. *See* SEC Release 34-29315, *supra* note 327.

356. "Shareholder Proposals—Rule 14a-8," Remarks of Richard Y. Roberts, Commissioner of the SEC, before the American Society of Corporate Secretaries, Oct. 5, 1991, at 1.

357. *See generally* GRAEF S. CRYSTAL, IN SEARCH OF EXCESS: THE OVERCOMPENSATION OF THE AMERICAN EXECUTIVE (1991); Steve Lohr, *Recession Puts a Harsh Spotlight on Hefty Pay of Top Executives*, N.Y. TIMES, Jan. 20, 1992, at A1, D8; *What is a CEO Worth?*, N.Y.L.J., Feb. 20, 1992, at 5.

358. *See* Barbara Franklin, *Issue for Securities Bar: Proxy Reform, Small Business Rules Debated*, N.Y. L.J., Mar. 12, 1992, at 5. The SEC is currently considering proposed changes in the way executive compensation is reported: (1) a summary table containing salaries, bonuses and the value of stock grants and options; (2) a table showing changes in compensation compared to changes in shareholder returns; and (3) explanations of factors used in setting compensation levels. *Id.*

359. 17 C.F.R. § 240.14a-8 (1992). A record or beneficial holder of 1% or $1000 in market value of corporate securities entitled to vote may submit one proposal to be included in the corporate proxy materials. Rule 14a-8(a)(1). The corporation may omit the proposal only if it is excludable under one of the provisions of Rule 14a-8(c). *See infra* notes 362-65 and accompanying text.

360. *See* ALI Project, *supra* note 33, at § 3.02(a)(1) (stating that the board of directors of a publicly held corporation should "fix the compensation of, and, where appropriate, replace the principal senior executives"). Section 3A.05 recommends that large publicly held corporations establish a "compensation committee" composed of at least a majority of outside directors, to "[r]eview and recommend to the board, or determine, the annual salary, bonus, stock options, and other benefits, direct and indirect, of the senior executives," § 3A.05(b)(1), and "take steps to modify any executive compensation programs that yield payments and benefits that are not reasonably related to executive performance." § 3A.05(b)(2).

361. *See* Richard C. Breeden, Remarks at The Press Conference on

Institutional and individual[362] shareholders have repeatedly attempted to address the question of executive compensation through shareholder proposals.[363] However, these proposals were routinely excluded because under Rule 14a-8 as interpreted by the SEC, executive compensation was considered a matter of "ordinary business."[364] Abandoning its former position, the SEC has announced its intention to require inclusion of shareholder advisory[365] proposals concerning executive or director compensation in corporate proxy statements.

In a system of bounded managerialism, shareholders need mechanisms to monitor and communicate with their directors. That relationship must, however, leave management independent and secure enough to withstand the pressure to engage in short-term decisionmaking. Thus, although reforms directed at the amplification of shareholder voice (such as requiring inclusion of shareholders' non-binding advisory proposals concerning executive compensation) are desirable counterweights to management, they should fall short of transferring control of detailed corporate matters to the shareholders by means of the proxy process.

e. Taxing Short-term Gain: Disincentive to Liquidity

If the tendency to "exit" exhibited by shareholders exacer-

Corporate Executives' Compensation (Feb. 13, 1993) (transcript available in LEXIS, Nexis Library, Federal News Service File) [hereinafter Breeden Remarks].

362. *See, e.g.*, Kevin G. Salwen, *The People's Proxy: Shareholder Proposals on Pay Must Be Aired, SEC to Tell 10 Firms*, WALL ST. J., Feb. 13, 1992, at A1 (reporting that the SEC reversed its position of many years by requiring the inclusion in Bell Atlantic Corp.'s proxy statement of a shareholder proposal by the owner of seventy-six shares concerning $4.2 million executive bonus pool).

363. *See* Kevin G. Salwen, *Shareholders Likely to Get Vote on Pay*, WALL ST. J., Feb. 3, 1992, at A3. In 1986 there were 35 shareholder proposals concerning compensation and benefits; in 1990 there were 110. *See* Breeden Remarks, *supra* note 361 at 2.

364. *See* 17 C.F.R. § 240.14a-8(c)(7); *supra* notes 358-59 and accompanying text. Other relevant possible grounds for exclusion would include claims that such proposals are not proper subjects for shareholder action under state law, Rule 14a-8(c)(1), or contained false or misleading statements, Rule 14a-8(c)(3).

365. Rule 14a-8 already distinguishes between proposals "that mandate[] certain action by the . . . board of directors" from those "recommending or requesting such action." *See* Rule 14a-8(c)(1) note.

bates the problem of short-term decisionmaking,[366] it might be beneficial to place some limits on liquidity. An obvious possibility would be a system of tax incentives intended to encourage investors to invest for the long term. This tax would be similar in principle to the now-defunct long-term capital gains tax. Under such a system, gains from the short-term sale of equity (or derivative securities)[367] could be taxed at a high rate; the tax rate would decrease, however, the longer the holding period prior to the sale.[368] Such a provision would work dramatic behavioral changes in securities markets, especially among short-term speculators such as arbitrageurs.[369] The provision would have to provide exemptions for certain traders whose short-term trades are essential for the market, such as market makers and exchange specialists. Moreover, lawmakers would have to determine which transactions other than ordinary market trades, for instance, involuntary corporate transactions such as forced sales after a merger, triggered the tax.[370]

If Congress were to adopt such a tax, it would radically alter, or, in the case of a 100% tax on short-term gain, virtually eliminate, the active market in options, futures and other index-related short-term investments. Although this would generate considerable controversy,[371] the overall impact, after the dust settled, might be entirely salutary. If index futures

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366. *See supra* notes 117-30 and accompanying text.

367. *See infra* notes 371-73 and accompanying text.

368. *See* LOWENSTEIN, *supra* note 3, at 86-87, 204-05, 207 (endorsing proposal by Warren Buffett that gain from sale of stocks be taxed at 100% if stocks were held for less than one year). *See also* David Wessel, *Tsongas, Clinton Differ on Strategies for Spurring U.S. Economic Growth*, WALL ST. J., Mar. 2, 1992, at A14 (Tsongas advocating three policies: (1) a cut in capital gains tax for equity securities only, (2) a declining tax rate tied to length of time securities are held, (3) a more rapidly declining rate for investments in new businesses.)

369. For example, in the case of a tender offer, long-term shareholders would profit from the takeover bid, but arbitrageurs who began making purchases in contemplation of the imminent offer would be taxed at 100% of their gain.

370. *See* LOWENSTEIN, *supra* note 3, at 87.

371. Some commentators have suggested that the availability of such derivative instruments increases market efficiency. Board of Governors of the Federal Reserve Bd. et al., A STUDY OF THE EFFECTS ON THE ECONOMY OF TRADING IN FUTURES AND OPTIONS 207-209 (1984); W. Gary Simpson & Timothy C. Ireland, *The Impact of Financial Futures on the Cash Market for Treasury Bills*, 20 J. FIN. & QUANTITATIVE ANALYSIS 371 (1985).

and options, introduced in the early 1980s, have "contributed significantly to shifting the markets' focus from long-term to short-term strategies,"[372] proposals likely to limit the proliferation and active trading of derivative instruments would be welcome.[373]

2. Facilitating Relationship Banking

One obvious difference between corporate decisionmaking in the United States and its competitors, Japan and Germany, is the role of banks in corporate affairs.[374] As noted above, banks are actively involved as corporate monitors (directors), equity holders and major creditors of German and Japanese corporations.[375] Banks have considerable influence, particularly in times of uncertainty or crisis, over corporate decisionmaking; indeed, they have been able to prevent major dislocations and enable ailing corporations to make relatively painless recoveries from financial distress.[376] At least in part as a result of these intimate business relations, Japanese and German corporations enjoy a significantly lower incidence of bankruptcy and lower cost of capital than U.S. corporations.[377]

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372. Hazen, *supra* note 77, at 163, 166.

373. The proper regulatory response to the active market in derivative investments is beyond the scope of this article. *See id.* For a suggestion that regulators should abandon their current laissez-faire regulatory posture and "seriously consider limiting derivative investments and trading strategies with a view towards restoring some stability in the financial markets." *See id.* at 207.

374. It may seem anomalous to take the view that empowering institutional shareholders generally would be a "false start," *see supra* notes 314-31 and accompanying text, while facilitating bank involvement may be a desirable reform. Several obvious differences are noteworthy. Banks, as institutions that would be both creditors and owners under suggested reforms, *see infra* notes 388-94 and accompanying text, would contribute judgment that would balance the short-term, more risk-preferring perspective of shareholders, against the more long-term, cautious interests of the firm's creditors. Thus, they would not necessarily exacerbate an already heavily share price-driven agenda that has distorted corporate decisionmaking.

375. *See supra* notes 209-23 and accompanying text.

376. *See supra* notes 227-38 and accompanying text.

377. *See supra* notes 209-38 and accompanying text. This problem is exacerbated by the modern U.S. banking practice of "securitizing" loans into parts (securities) that can be traded to third parties. Although this

By contrast, although in the early 20th century U.S. banks played similar complex and central ownership-advisory-monitoring roles for their corporate customers,[378] they are effectively prohibited from such multiple role-playing under present U.S. law.[379] These legal prohibitions, coupled with available alternative sources of commercial credit (including foreign banks), have resulted in what one commentator has referred to as "the demise of relationship banking" in the United States.[380]

Since the 1930s and the enactment of the Glass-Steagall Act, the U.S. has followed a segregated model of financial regulation: commercial banking is strictly separated from investment banking.[381] Following some variation of the "universal" bank-

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process generates fees for the bank that originates and services the loan and spreads the risk of failure, the borrower may lose out in the long run. A securitized loan is far more difficult to restructure in times of financial crisis. Indeed, under certain circumstances, a single noncooperating participant may prevent successful restructuring. *See* JACOBS, *supra* note 306, at 150-52.

378. It has been suggested that the old-fashioned "bank-dominated form of capitalism" existing side by side with the "stock market form of capitalism" might achieve the integration of long-term investment horizon with flexibility and entrepreneurship. *See* Hale, *supra* note 225, at A10.

379. As has been noted, bank holding companies are permitted limited ownership. *See supra* note 214 and accompanying text. In addition, bank trust departments vote blocks of shares on behalf of their beneficiaries, although trust holdings are also severely fragmented. *See* Roe, *supra* note 117, at 18.

380. JACOBS, *supra* note 326, at 143. Despite the dismal record of U.S. banking institutions in recent years, the claim is that talented individuals who have increasingly preferred other, more dynamic careers than are possible under the current regulatory scheme would be drawn to banking once freed from stultifying and anticompetitive restrictions. *Id.* at 145-146. Such individuals would soon acquire the professional skills they now lack if given the same opportunity afforded to Japanese and German bankers to exercise them creatively. *Id.* at 160. *Cf.* Michael Klausner, *An Economic Analysis of Bank Regulatory Reform: The Financial Institutions Safety and Consumer Choice Act of 1991*, 69 WASH. U. L.Q. 695, 736-37 (1991) (beneficial effects of expanding range of investments and services open to banks).

381. *See* Banking Act of 1933, §§ 16, 20, 21, 32, 12 U.S.C. §§ 24, 377, 378, 78 (1988). *See generally* John D. Hawke, Jr., *The Glass-Steagall Legacy: A Historical Perspective*, 31 N.Y.L. SCH. L. REV. 255 (1986) (setting out the basic requirements and prohibitions of the Banking Act of 1933 and defininining the principle issues that have arisen under the Act). The complex regulation of precisely which securities activities banks and their affiliates may or may not engage in will not be rehearsed here. *See, e.g.*, Klausner, *supra* note 380, at 700-03. It is interesting to note,

ing model,[382] European banks, typically, impose no such restrictions on the provision of financial services. Although this segregation of financial services in the U.S. was enacted in reaction to the Great Depression and a nationwide flood of bank failures, many commentators[383] argue that it now interferes with the ability of U.S. institutions to compete in world financial markets.[384]

Since banks can no longer own their customers' equity outright, they deal with corporations from a pure "creditor" perspective. Creditors do not share in their debtors' profits beyond the contractual debt; they are therefore likely to prefer risk-averse corporate investment strategies that do not threaten their security interest. If these creditors also held their customers' equity, that ownership interest might mitigate their strong risk aversion. They would anticipate sharing the potential profits and become more tolerant of entrepreneurial (more

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however, that banking institutions have sought (and won) regulatory approval for an expanding universe of nonbanking activities, frequently opposed by the Securities Industry Association. *See* Klausner, *supra*, at 742 & nn.145-49. However, legal restrictions constrain the banks' ability to perform these services. *Id.* at 742-43 nn.150-56. It seems reasonable to conclude that investors might be the winners were banks to compete with securities firms in the provision of securities-related services.

382. Donald E. McNees, *Global Financial Market Structure: Implications of Regulations For Competitiveness*, ISSUES IN BANK REG., Fall 1990, at 2, 4-5. These "all service" institutions may be divided into "universal" banks (institutions that are granted all financial powers, where broad ownership of and by commercial enterprises is permitted) and "omnipurpose" banks (institutions that are granted all financial powers, where ownership of and by commercial enterprises is limited). *Id.* at 4. Germany is the predominant example of a universal banking system. *Id.* Japan follows the U.S. model of segregated financial services, although Japanese banks are permitted to hold equity securities. *Id.* at 4-5. *See supra* notes 214-19 and accompanying text.

383. For dissenting voices, *see, e.g.*, Litan, *supra* note 225 (arguing that if banks were allowed to engage *directly* in other financial non-banking activities, it "would stretch the federal safety net — deposit insurance and access to the Fed's discount window — under not just banks but much of the rest of the economy as well"). One solution to the deposit insurance problem might be the creation of specialized "insured deposit banks." *See infra* notes 388-91 and accompanying text.

384. Indeed, such limitations severely restrict additional sources of profit for these institutions, which therefore must maintain higher interest rates, thereby contributing to our uncompetitively high cost of capital. Klausner, *supra* note 380, at 728-29; *see supra* notes 202-25 and accompanying text.

risk-accepting) strategies favored by optimistic owners.

While some urge adoption of a universal banking system in this country,[385] others fear this approach could result in catastrophic demands on the system of federal deposit insurance.[386] As banks begin to invest their capital in corporate securities, they risk making poor choices that increase the risks to their depositors' accounts, and therefore the risks to the federal treasury.[387]

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385. *See, e.g.*, McNees, *supra* note 382, at 17-19. In a study undertaken by the accounting firm KPMG Peat Marwick at the request of the United States Congress Office of Technology Assessment, bankers worldwide identified the U.S. banking regulatory system as the most expensive in terms of overhead cost to the regulated institution and the most complex and confusing. *Id.* at 14. As this article and others have observed, *see supra* notes 186-91 and accompanying text, the cost of capital (including the cost of debt), is significantly higher in the U.S. than in Germany and Japan. It does not seem unreasonable to suggest that our more byzantine regulatory system bears significantly on those costs.

The three classes of commercial banks (national banks, state member banks of the Federal Reserve System, and state nonmember banks) are subject to a bewildering network of regulators and regulations. National banks are regulated by the Comptroller of the Currency and automatically become members of the Federal Reserve System, subject to the Federal Reserve Board. State banks are subject to state banking authorities; additionally, state "member" banks choose to join the Federal Reserve System and are therefore subject to the Federal Reserve Board. In addition to state banking authorities, "nonmember" state banks are subject to Federal Deposit Insurance Corporation (FDIC). All bank holding companies are subject to the Federal Reserve Board. *See* Klausner, *supra* note 380, at 700 n.17. Contrast this with the regulation that applies to "universal" banking systems proposed for the European Economic Community (EEC), i.e., where banks may engage in the securities business, own equity and be owned by non-financial organizations. Such systems will typically have a single regulator overseeing all non-insurance financial institutions. *See* McNees, *supra* note 382, at 6.

386. *See, e.g.*, Litan, *supra* note 225.

387. There is some controversy whether adoption of a universal banking model would increase the risks of bank failure. *See* McNees, *supra* note 382, at 19. Indeed, some scholars now question the Depression era analysis that led to the segregated regulatory system in the first place. *See* Klausner, *supra* note 380, at 701-02 & sources cited in nn.25-26.

A legitimate danger exists that banks and other financial institutions owning shares and serving on corporate boards of directors may be able to engage in successful market manipulation. *See Liquidity Versus Control*, *supra* note 83, at 1335 & n.224 (citing others who have already warned of this danger). *See also* Steve Thel, *The Genius of Section 16: Regulating the Management of Publicly Held Companies*, 42 HASTINGS L.J. 391, 399 (1991) (suggesting that § 16 was intended primarily to eliminate insiders' incentives to manipulate stock price by strategic corpo-

Even though this pessimistic scenario is not inevitable, the universal banking model seems likely to encounter political opposition. Operating within the existing "holding company" regulatory model would be a less controversial possibility.[388] Congress could authorize uninsured bank *affiliates*, within a bank holding company structure, to engage in the full range of securities activities.[389] The danger of abusing federal deposit insurance could thus be confined by separating out these securities operations and establishing federally insured and uninsured banks. Certain banks could serve as uninsured depository institutions, free to invest in a full range of securities. Such banks would pay their uninsured depositors a market-based rate of return that adequately reflects their level of investment risk. Federal deposit insurance could be limited to "insured deposit banks"—narrow institutions that would accept all deposits, without limits, but pay a lower rate of interest that reflects a lower risk factor.[390] These insured deposit banks would be permitted to invest only in government or high-grade corporate securities.[391]

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rate decisionmaking). A related concern is the potential for abuse by the banks (or indeed any other financial institutions) that serve on corporate boards of directors and are privy to confidential information that is material to the interests of other customers, etc. The possibilities include conflicts between the bank and the corporation itself and conflicts between third parties that may be in business with the bank and the corporation. *See, e.g.*, Klaus J. Hopt, *Self-Dealing and Use of Corporate Opportunity and Information: Regulating Directors' Conflicts of Interest*, *in* CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES 285, 306 (Klaus J. Hopt & Gunther Teubner eds., 1985). Such conflicts abound in other contexts as well, and are addressed through federal (and state) prohibitions against insider trading. *See, e.g.*, Securities Exchange Act of 1934 § 10(b); SEC Rule 10b-5; 17 C.F.R. § 240.10b-5 and state laws imposing strict standards of loyalty and good faith on fiduciaries. The problem also may be mitigated by delegation of board representation to professional directors. *See* Gilson & Kraakman, *Outside Directors*, *supra* note 10.

388. *See* Bank Holding Company Act of 1956, 12 U.S.C. § 1842(a) (1988).

389. *See, e.g.*, S.696, 102d Cong., 1st Sess. § 203(a)(3)(C) (1991) (proposing amendment to Bank Holding Company Act of 1956 which would permit establishment of securities and insurance affiliates with full range of securities activities); Klausner, *supra* note 380, at 745-46.

390. For a discussion of "narrow" banking, see generally ROBERT E. LITAN, WHAT SHOULD BANKS DO? (1987); Kenneth E. Scott, *Deposit Insurance and Bank Regulation: The Policy Choices*, 44 BUS. LAW. 907 (1989).

391. Investments in U.S. government or agency securities, AAA- or

This system would extend to U.S. banking institutions the necessary freedom to compete with other nonbanking or foreign banking institutions in the world marketplace for financial services. By segregating insured deposits in these special banks, and insulating them (to a greater degree than is now possible) from risk, this regime can preserve and even expand deposit insurance for risk-averse depositors, while diminishing the risk to the U.S. treasury of future bailouts.

Under such a regime, it might be possible to resurrect relationship banking. The relationship banking of the pre-Depression era operated to the advantage of corporations in several ways. Corporations established lasting relationships with their major creditor based on reciprocal advantage and shared information. Banks not only owned shares of their customer corporations, they frequently held seats on their board of directors, worked cooperatively with corporate debtors-in-trouble to contain risk, minimize losses and restructure debt outside of the formal bankruptcy process.[392]

Removing banks from their active and constructive involvement in corporate affairs left a monitoring void because managers were freed from the watchful eyes of informed financial professionals who combined creditor and ownership perspectives. This void, in the eyes of some commentators, was filled for a time (albeit with mixed results)[393] by the market discipline of the hostile takeover.[394] As that disciplinary mecha-

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AA-rated corporate bonds, and A1-P1-rated commercial paper would be the only permissible investments for such insured deposit banks. Absent a national catastrophe, there should be minimal risk of failure and, therefore, minimal drain on the federal deposit insurance funds. JACOBS, *supra* note 326, at 235; *see also* James Tobin, *Keep Deposit Insurance but Protect Taxpayers*, WALL ST. J., May 29, 1991, at A10.

392. *See* JACOBS, *supra* note 326, at 143; Kim, *supra* note 214. Despite its advantages, relationship banking has disappeared in the United States, not simply because of the prohibitory bank regulations described above. *See supra* notes 209-20 and accompanying text. U.S. banks also risk exposure to substantial liability under a variety of doctrines that may create lender liabilities, subordinate creditor-*owner*'s claims, destroy the priority in bankruptcy of bankers that also own equity, or create conflicts of interest concerning disclosure of confidential information. Thus, even if banks were suddenly authorized to own corporate equity outright, such risks of liability would create their own powerful disincentives. By contrast, Japanese and German banks face no comparable exposure except for acts of fraud or manipulation. *See* JACOBS, *supra* note 326, at 158-60.

393. *See supra* notes 300-03 and accompanying text.

394. *See supra* notes 296-313 and accompanying text.

nism has faded from the scene, the need for effective monitoring has grown. Restored multi-layered relationships between bankers and corporate managers might partially fill that void. Banker-owners who have forged lasting relationships with corporate clients can inject useful creditor-owner perspectives on risk and entrepreneurship into the mix of decisionmaking. Moreover, by lowering financial risk, and therefore the cost of capital, for corporations, such relationships may lower a critical barrier to desperately needed long-term capital investment in U.S. industry.

3. Keying Executive Compensation to Corporate Performance[395]

In 1930, in the depths of the Depression, Babe Ruth was informed that he was being paid more than President Hoover.[396] He is said to have replied, "Well, I had a better year than he did." The "Babe" had an instinctive understanding of compensation *ex post* as reward for past excellence, but compensation can also be viewed *ex ante*, as incentive for future performance.[397] As U.S. productivity falters, that traditional view has increasingly come under fire. American chief executives are the best paid in the world—typically earning many times more than their counterparts in Japan and Germany.[398]

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395. This article is not attempting to catalog or discuss the intricacies of the modern system of executive compensation. Rather, it attempts to discuss in general terms the implications executive and directors' compensation may have on short- and long-term corporate decision-making.

396. Ruth was paid $80,000; Hoover received only $75,000. *See* Crystal, *supra* note 357, at 26.

397. This is a widely accepted traditional view of productivity. *See, e.g.*, THOMAS J. PETERS & ROBERT H. WATERMAN, JR., IN SEARCH OF EXCELLENCE 43 (1982) (describing one tenet of the "old" business rationale as "[g]et the incentives right and productivity will follow. If we give people big, straightforward monetary incentives to do right and work smart, the productivity problem will go away. Over-reward the top performers.").

398. The numbers are startling: at the biggest U.S. corporations, CEOs earn an average total of $3.2 million while their Japanese counterparts earn an average of $525,000. Robert Null & Joyce Barnathan, *How Much Japanese CEOs Really Make*, BUS. WK., Jan. 27, 1991, at 31, 31. Other commentators place the figures somewhat lower, though stark contrasts remain. *See* Crystal, *supra* note 357, at 204-07 (reporting that the typical U.S. CEO earns approximately $2.8 million in salary and bonus while the typical Japanese CEO earns approximately $310,000 in cash

If our system of incentives were working properly, executive pay would correspond to corporate performance. Unfortunately, disappointing corporate performance is rarely reflected in annual executive compensation;[399] indeed, executive compensation may be becoming less rather than more sensitive to fluctuations in corporate performance.[400]

The precise nature of the problem is disputed. In a recent book, *In Search of Excess*, Professor Graef Crystal claims that levels of executive compensation are simply excessive.[401] Professors Jensen and Murphy disagree, contending that the real problem is not how much chief executive officers (CEOs) are paid but *how* they are paid.[402] An effective system for compensation would rationally combine the carrot with the stick: substantial predictable rewards for outstanding performance and substantial predictable penalties or dismissal[403] for fail-

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compensation and the typical German CEO earns approximately $735,000 in salary and bonus).

399. *But see Kodak Chief Takes Pay Cut*, N.Y. TIMES, Mar. 9, 1992, at D2 (chief executive officer of Eastman Kodak Company took 19% pay cut in 1991 because of company's poor performance).

400. *See* Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, But How*, HARV. BUS. REV., May-June 1990, at 138-53.

401. In Professor Crystal's view, "U.S. senior executives are paid so far in excess of U.S. workers as to raise fundamental questions of equity, and even decency." Crystal, *supra* note 357, at 241. While the wages of the average American worker declined over the last 20 years by 13%, the pay of a typical CEO of a major corporation more than tripled. *Id.* at 27. An even more telling statistic is the change in the average pay multiple: in 1974 a typical CEO earned approximately 35 times the pay of an average manufacturing worker; today the multiple is closer to 120 times the pay of an average manufacturing worker. *Id.*

402. *See* Jensen & Murphy, *supra* note 400, at 138. Jensen and Murphy conclude that top executives "are not receiving record salaries and bonuses." *Id.* Indeed, they claim that pay levels are only now beginning to equal those of 50 years ago. *Id.* at 139. The average pay level of CEOs of NYSE-listed companies in 1938 was $882,000 in 1988 dollars. Between 1982 and 1988, the average salary and bonus for CEOs of comparable companies was $843,000. *Id.*

403. While conceding that some executives are overpaid, Professor Gary Becker asserts that the real problem with corporate competitiveness is the difficulty in ousting incompetent executives from their positions. *See* Gary S. Becker, *The Problem Is Not What CEOs Get—It's Getting Them to Go*, BUS. WK., Mar. 2, 1992, at 18. Given the degree of control CEOs exercise over even independent directors, *see supra* note 340 and accompanying text, they are effectively protected from removal for poor performance except through hostile takeovers, which frequently trigger

ure. Moreover, any payment system should be sufficiently sensitive to corporate performance to make a lasting impression, whether favorable or unfavorable, upon the person being compensated.

According to Professors Jensen and Murphy, typical cash compensation systems are too insensitive to corporate performance since for every $1,000 change in shareholder wealth the median CEO experiences only a $2.59 change in personal wealth. Thus, a $10,000,000 market loss for the corporation translates into a typical personal loss of $25,900. This is "not much of a disincentive for someone who earns on average $20,000 per week."[404] Professors Jensen and Murphy advocate greater alignment of CEO interests with shareholder interests by making CEOs into substantial shareholders. If CEOs owned signficant percentages of their corporation's shares,[405] they would experience a more intense "feedback effect" from fluctuations in share price.[406] This, in turn, would create more effective incentives to aggressively avoid waste and pursue profitable strategies.

Although CEOs frequently receive stock options, this component of deferred compensation does not necessarily align CEOs' interests with shareholders. For example, although both CEO option-holders and shareholders benefit from rising prices, CEOs alone avoid loss when prices begin dropping (by not exercising the option). In fact, most corporations will rewrite their CEO's option grant at a lower strike price if share price has declined. Thus, CEOs can only benefit from stock options, never lose.[407] Moreover, since CEOs' gains from stock options are geared entirely to share price, CEOs may be drawn toward short-term business strategies directed at inflating share price for a specific period; such manipulative strategies may not be sustainable over the long-term, leaving the corporation unable to compete in the years ahead.[408]

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costly golden parachutes. Fixed-term (three to five year) renewable contracts would institutionalize periodic performance reviews and facilitate efficient removal of those who perform poorly. *See* Becker, *supra*.

404. Jensen & Murphy, *supra* note 400, at 140.

405. However, it is virtually impossible for CEOs in the "truly giant" corporations like GM or IBM to own sufficiently large percentages of shares. *Id.* at 141. Indeed, Jensen and Murphy consider that fact to be a "real cost associated with bigness." *Id.*

406. *Id.*

407. *See* Crystal, *supra* note 357, at 175-85.

408. For example, the CEO of General Dynamics Corp. was promised

As noted above, the issue of executive compensation is traditionally a matter of state law, committed to board control and subject to the limits of business judgment doctrine, and perhaps, in egregious cases, the doctrine of waste.[409]

Professor Crystal has proposed certain other changes, not involving government intervention, that he believes can effect reform of the executive compensation system. In particular, he recommends bolstering the effectiveness of the executive compensation committee[410] by requiring it to hire an independent compensation consultant free of any ties to the corporation or its CEO.[411] This consultant would attend all compensation committee meetings, review existing compensation plans and prepare at least annual written reports for the committee and full board concerning all existing and proposed plans, particularly that of the CEO. Presumably, such a consultant would have more independence from the CEO than her traditional counterpart.[412]

In addition to these steps, a fundamental restructuring of

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twice his annual salary of $800,000 as a bonus if the corporation's average stock price remained above $45.56 for 10 consecutive trading days. The CEO told market analysts that corporate earnings were above expectations and that management intended to return "excess cash" to shareholders. Share price rose to $46 and after 10 days, the CEO earned a $1.6 million bonus. *See* Robert J. McCartney, *A Most Unusual Executive Bonus Plan*, WASH. POST, Oct. 21, 1991, at A1.

409. *See supra* notes 362-64 and accompanying text; Rogers v. Hill, 289 U.S. 582 (1933).

410. *See supra* note 360 and accompanying text. The committee needs all the bolstering it can get, since even the outside directors that comprise the committee are vulnerable to the CEO's influence. Therefore, Professor Crystal suggests a formalistic decisionmaking structure involving "comparator" groups of industries against which to measure executive and director levels of compensation. *See* Crystal, *supra* note 357, at 244-45.

411. *See* Crystal, *supra* note 357, at 242-43. CEOs frequently employ their own corporate compensation consultants, but, not surprisingly, they may be eager to please and unlikely to bite the hand that pays them. *Id.* at 242. Of course, it seems reasonable to inquire how long a *committee's* consultant will remain on the payroll if the recommendations frustrate the CEO's expectations.

412. As an added protection, once a compensation committee has hired its consultant, the consultant's name should be required to be disclosed to shareholders in the corporate proxy statement. Moreover, given the potential for conflict with the CEO over compensation, the consultant should enjoy the limited protection afforded to outside auditors under the proxy rules: if the consultant has been dismissed, the corporation should have to say so and explain why. *Id.* at 244.

executive compensation is needed so that the incentives of the managers are better aligned with the long-term profitability of the firm. This is not the place for a detailed proposal, but the essential features of the needed restructuring seem evident. First, the incentive component must be a large enough share of the overall compensation package to provide a meaningful carrot for spurring improved performance. Second, the valuation of the incentive component cannot be subject to executive manipulation. Third, the incentive should work in both directions; the executive should face both the prospect of an upside gain and a downside loss. Finally, the incentive should provide for a substantial holding period before any gain can be realized in order to ensure a long-term horizon. Federal tax laws might be utilized to motivate firms to adopt such incentive programs for key executives.[413]

4. Facilitating Employee Voice

The example of German codetermination suggests that giv-

413. Consider, for example, Professor Crystal's proposal to have the government offer long-term capital gains treatment to stock options that meet certain requirements so that they "[promote] the desired long-term behavior." Crystal, *supra* note 357, at 248. First, the initial strike price of the option would be established by averaging the share price during the preceding two years to prevent executives from taking advantage of inside information by manipulating the date of the granting of the option. Second, the initial strike price would be increased to include a minimum shareholder return, possibly keyed to government bonds carrying a 10-year maturity. This would ensure that the executive receives no benefit unless market price at the time of exercise exceeds the minimum return. Third, the final strike price would be lowered whenever dividends were declared during the ten-year period following the grant so as to encourage distribution of dividends. Fourth, the executive could not exercise until the end of ten years after the grant; this would prevent cashing in simply to take advantage of a momentary rise in share price. Finally, the payoff would not involve the exercise of a stock option at all. The executive would receive a payment (or no payment at all) at the end of the tenth year. The payment would be made *only if* the "adjusted final market price per share," determined by the average stock price over the two years preceding the end of the tenth year, exceeded the strike price per share, as adjusted to reflect the minimum shareholder return. *Id.* at 248-50. Professor Crystal anticipates no net loss to tax revenue because, to compensate for the favorable long-term capital gains treatment of the incentive payout, taxes would be increased on any compensation received by the executive other than the tax-approved long-term incentive. *Id.* at 251.

ing employees an enhanced voice in the decisionmaking process of the firm[414] also could serve as another useful counterweight to managerial discretion. Employees, too, have an interest in the long-term success of the enterprise. Moreover, participation may be a key to enhanced productivity and receptivity to performance-based compensation.[415] However, employees may also suffer from truncated time horizons which may be at variance with the firm's profitability.[416] The presence of unions further complicates matters, given the adversarial nature of U.S. labor relations. The German model appears to work in part because of the different labor relations climate in that country and the fact that employee representation is offset by the very significant role banks play in corporate governance.

The merits of formal inclusion of employee representatives on the board of directors is beyond the scope of this article. A less controversial step would be to remove the obstacles that our labor laws presently erect to greater employee involvement in the decisionmaking processes of the firm.[417]

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414. The German system operates both at the board level, where employees sit on the supervisory board, and at the operational level of works councils. *See supra* note 234 and accompanying text. Either or both forms of labor participation might be considered for implementation here.

415. *See, e.g.*, David I. Levine & Laura D'Andrea Tyson, *Participation, Productivity, and the Firm's Environment*, *in* PAYING FOR PRODUCTIVITY 183-244 (Alan S. Blinder ed., 1990).

416. This is the reason why Professors Jensen and Meckling question the efficiency of employee ownership and/or management arrangements. *See* Michael C. Jensen & William H. Meckling, *Rights and Production Functions: An Application to Labor-managed Firms and Codetermination*, 52 J. BUS. 469, 481-84 (1979).

417. Useful first steps include repeal of the prohibition of employee representation plans in the non-union sector, *see* NLRB v. Cabot Carbon Co. 360 U.S. 203 (1958), and repeal of the exclusion of "managerial employees" from union representation, *see* NLRB v. Yeshiva U., 444 U.S. 672 (1980). Professor Weiler also advocates mandatory establishment of "employee participation committees" in every company. *See* Weiler, *supra* note 280, at 44. The question of union directors on the board is considered in, for example, Helen S. Scott, *Union Directors and Fiduciary Duties Under State Corporate Law*, *in* LABOR LAW AND BUSINESS CHANGE 115 (Samuel Estreicher & Daniel G. Collins eds., 1988); Robert A. McCormick, *Union Representatives as Corporate Directors, The Challenge to the Adversarial Model of Labor Relations*, 15 U. MICH. J.L. REF. 219 (1982).

CONCLUSION

We rely on corporations for the production of social wealth, and the American firm is falling down on the job. Many factors no doubt contribute to the declining competitiveness of our economy. This article has suggested that short-term decisionmaking by managers and shareholders may enrich some individuals today, but at great cost to the economy. Corporate managers must be encouraged to refocus their vision in a system of laws that rewards investment for the future, because, as John Maynard Keynes has written, "there is no such thing as liquidity of investment for the community as a whole."[418]

418. JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 155 (1936).